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The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

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VOL. 58 DECEMBER, 1934 No. 6

EDITORIAL

Certification According to Instruction

It is reported that a state banking commissioner has recently issued, in reference to certification of accounts, a ruling which we believe is entirely unique and quite undesirable. The story goes that the ruling requires that the accountant who audits the accounts of building and loan associations must follow a fixed formula which leaves no latitude at all for qualification or explanation. The certificate must state that in the opinion of the accountant the accounts are correct or else the accountant must refuse to certify. This is very much like the rule of court that where a witness can answer yes or no he must do so; but it is well known that many questions will not permit adequate reply without some explanatory comment. The bank commissioner is said to have made his ruling to avoid a multiplicity of qualifications in certificates, many of which might be unintelligible to the share-holder. Consequently he has decided that there must be this fixed form which we have mentioned and beyond that nothing whatever so far as the certificate itself is concerned. But the commissioner evidently recognizes the necessity for something more comprehensive than a mere yes or no answer, because the ruling provides further that if any explanation is necessary it may be reported to the directors of the association for their information. The accountant, therefore, if this ruling holds, will find himself in an extremely awkward position. There may be, and probably will be, many instances in which he will feel that his duty to the share-holder calls for exposition of reasons and facts for the protection of the share-holder himself.

No Restriction Should be Permissible

There is, as everyone knows, a marked trend today toward better and more indicative financial reports, and accountants throughout the country, responding readily to the demand for greater frankness, are making every effort to present reports and certificates which carry to the reader all the knowledge of the facts to which the reader is entitled. Now comes this extraordinary ruling of a state banking commissioner, which looks like a reversion to the dark ages, when the share-holder was unimportant and was not told any more than the directors thought was good for his soul. There are very few accounts which can be certified without some explanatory phrase or sentence in the certificate. This does not mean that there need be anything wrong in the accounts themselves or in the financial condition of the company. It does mean that there are things which can not be classified as correct or incorrect without a few words of qualification. Indeed, there are probably many cases in which a monosyllabic response to the question: Is this correct or not? would be misleading. If the banking commissioner's rule is followed the accountant who finds that some qualification is necessary will be obliged to refuse to certify in the short form which is desired by the commissioner, and it is easily conceivable that such a refusal to certify might work an injury to the association in question. If the accountant had audited the accounts of a building and loan association and because of this restrictive ruling refused to certify, the share-holders and the general public as well might be forgiven for coming to the conclusion that the association was in an unsound condition, when as a matter of fact it might be prosperous and its affairs in perfect order.

Refusal to Certify May be Unfair

A fine legal point might then arise as to the liability of the accountant who refused to certify and thereby involuntarily cast upon the association a shadow of doubt. Perhaps the defense of the banking commissioner would be that any qualifications or explanations addressed to the directors would be sufficient indication of the accountant's opinion; but as a matter of fact letters to boards of directors are not public property and usually are not accessible to share-holders. There is nothing new in this contention. In an English case involving the London and General Bank, Limited, in 1895, the decision of the court of appeals contained the following:

". . . The balance-sheet and certificate of February, 1892—that is, for the year 1891—was accompanied by a report to the directors of the bank. Taking the balance-sheet, the certificate, and report together, Mr. Theobald (the auditor) stated to the directors the true financial position of the bank, and if this report had been laid before the share-holders, Mr. Theobald would have completely discharged his duty to them. Unfortunately, however, this report was not laid before the share-holders, and it becomes necessary to consider the legal consequences to Mr. Theobald of this circumstance. A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them to ask for more. Information and means of information are by no means equivalent terms. In this case I have no hesitation in saying that Mr. Theobald did fail to discharge his duty to the shareholders in certifying and laying before them the balance-sheet of February, 1892, without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words 'The value of the assets as shown upon the balance-sheet is dependent upon realization' . . ."

An accountant who did obey such an absurd ruling as that which is the subject of present consideration would be not only unwise but untrue to his professional duty. There is a rather strong sentiment in favor of the shortest form of certificate which can express the accountant's opinion. There is no advantage in long and involved certificates; but brevity can be carried to the point of obscurity. It is ridiculous to attempt to limit to any specified form an expression of professional opinion, and no professional man should submit to arbitrary limitation of that sort. Probably the ruling which has been reported to us will arouse so much protest that it will have to be rescinded or so modified as to make it harmless. The principle involved, however, is important, and accountants should be on guard to check every effort to place a restraint upon their professional freedom of action. Every accountant has had experience of clients who wish to dictate the form of certificate—and we hope that every accountant has declined to accept any such dictation. The moment any professional man allows his professional liberty to be thus bounded, he makes his standing in the profession insecure. What reason may have animated the banking commissioner to utter such a ruling as that which we have described is unknown. There seems to be no logical excuse for it. It would be unacceptable to shareholder, accountant, the state department of banking and the general public. In fact, it is difficult to think of any benefit which could accrue from its enforcement. It seems probable, therefore, that it was merely an ill advised effort to standardize something which can not be absolutely standardized.

Two-Class Legislation Decried

Among the many valuable reports which were presented by committees at the annual meeting of the American Institute of Accountants last October was one emanating from the committee on state legislation. This report contained a survey of that form of certified-public-accountant legislation which has been variously described as "two class," "restrictive," etc. The laws which fall in this category provide for the registration of all men and women engaged in professional practice as accountants at the time of the enactment of the law. Thereby they create two sorts of licensed accountants: the certified public accountant and the registered public accountant. They provide also that there shall be no further accessions to the list of registered accountants. The natural result of this closing of the doors will be the gradual elimination of all professional accountants except those who are and those who will become certified public accountants. The report is an extremely able review of the supposed advantages and the manifest disadvantages of this kind of legislation, and the committee deserves commendation for the careful and thorough investigation which must have preceded the writing of the report. It is not necessary to reproduce the entire report, but the following preamble and resolution submitted by the committee to the council so comprehensively covers the subject that there is little to be added:

WHEREAS, the certified-public-accountant certificate is the recognized legal credential of professional public accountants in the United States, and

The business public has come to regard certified public accountants as qualified practitioners of accountancy, and

Passage of so-called restrictive accountancy laws necessarily extends state recognition to unaccredited accountants in practice at the time of enactment of such laws, and

Such recognition dilutes the value of the certified public accountant certificate by creating confusion in the public mind as to the distinction between certified public accountants and other licensed public accountants, and

Experience has shown that such recognition strengthens the political position of non-certified public accountants, facilitates their organization as a group and frequently results in efforts to obtain certified-public-accountant certificates by waiver, and

WHEREAS, restriction of the practice of accountancy would necessarily limit the definition of accountancy to only a few of the services which certified public accountants now customarily perform, and

WHEREAS, court decisions indicate that restrictive accountancy laws of the type proposed up to this time are apt to be unconstitutional,

Be It Resolved, that the council of the American Institute of Accountants regards the passage of restrictive accountancy laws of the so-called two-class type as inimical to the interests of the certified public accountant and of the business public.

Decision Not Hastily Made

After consideration of the report the council unanimously adopted the resolution. It is quite easy to understand why the restrictive or two-class form of bill has met with some support. At first glance it seems to offer a protection against extra-state competition, because it is not to be expected that an accountant, going into a foreign state for the purpose of completing an engagement, would care to go through the formalities and delays entailed by an effort to obtain a certificate in that state; and it might seem to the casual observer that the effect of this sort of law would be to strengthen the position of the accountants within each state. There has been in accountancy, as in every other profession, a good deal of dissatisfaction because of the encroachment upon local practice by men whose wider reputation has induced their employment by clients within a state. Nobody likes to feel that a practitioner from beyond the bounds of his own state is preferred to himself. This has been one of the causes of such support as has been rendered to the theory of restrictive legislation. The other contributing causes are indicated in the preamble of the resolution which we have quoted. We believe, however, that the great majority of accountants would oppose the adoption of the principle of restriction; and the fact that the Institute's council, representative of all parts of the country, unanimously adopted the resolution lends credence to our contention. This matter has been discussed more or less informally at many meetings of the council and of the Institute as a whole, but there was some hesitation about taking a definite stand until the experiment had had ample trial and opportunity to demonstrate its effects. Now it has seemed to the council that no further period of experiment is necessary and the resolution definitely places the Institute on record as opposed to what is generally regarded as an undesirable development of C. P. A. legislation.

Similar Action in New York

Following the meeting of the Institute at which the report of the committee on state legislation was considered and its recommendations were adopted, the committee on legislative survey of the New York State Society of Certified Public Accountants presented to that society a report upon the same subject. From this report we quote the following paragraphs:

"The particular problem seems to resolve itself into a question of whether the society should continue the position it has heretofore taken in favor of the so-called 'open-door' policy under which anyone might practise as a public accountant (but with strict limitation of the right to use the title of certified public accountant), or whether there should be some form of restrictive legislation which would bar from the public practice of accountancy in this state all those who were not recognized by the state as authorized so to practise.

"We are, however, prepared to say that we believe the society should not at the present time change the position it has heretofore taken against various proposals for restrictive legislation. This position is stated without believing that the society should say whether or not at some future date it might see some form, type or basis for restrictive legislation and control which it might feel would be appropriate or desirable or at least free from serious objection. . . .

"While we have heretofore expressed in this report the thought that the society should not at the present time change the position it has heretofore taken against restrictive legislation and while we would not wish here to weaken or in any way void that expression, we may state that there stand in our minds certain points without which no restrictive legislation in any event should receive the approval of the New York state society."

The report of the New York committee on legislative survey was presented to the society at a meeting on October 29, 1934, and after discussion was accepted. We find, therefore, that, while the attitude of the New York state society was not so definite as that adopted by the American Institute of Accountants, there was practical agreement between those two organizations. The state society's stipulation of seven qualifications which all restrictive laws would have to meet to be acceptable to the society seems to us to be tantamount to opposition to the two-class laws now in effect and to any scheme of similar legislation apt to be devised.

Development of Accounting Principles

One of the most important committees of the American Institute of Accountants is that which is known as the special committee on development of accounting principles. This is a new committee, appointed for the first time last year, but the accomplishments and purposes of the Institute since its inception have been largely concerned with the survey and analysis of the underlying principles which should govern the practice of accountancy. The appointment of the committee was merely putting in more concrete form the purpose of the whole organization. The committee consists of the chairmen of several committees and thus is representative of a large group of competent accountants. Its opinions and recommendations are worthy of close consideration. The report of the committee which was submitted at the meeting of council of the Institute October 15, 1934, was published in the *Bulletin* of the Institute. Attached to the report was a statement of certain principles which were enunciated by the Institute's committee on coöperation with stock exchanges. (These rules have already appeared in THE JOURNAL OF ACCOUNTANCY.) When the report of the special committee was reported to the council in October the rules were unanimously approved.

Treatment of Donated Stock

Special interest attaches to another section of the report of the special committee on development of accounting principles. The undesirable practice which gave rise to a new recommendation was discussed in these pages in October, 1934, in the course of comments upon the decision of the federal trade commission in the case of the Unity Gold Corporation. The committee recommended that the Institute put itself on record as to the treatment to be applied to a series of inter-related transactions comprising:

1. The issue of capital stock of a corporation ostensibly for property;
2. The donation of a part of such stock to the corporation;
3. The sale of a part of the donated stock for cash by the corporation.

The report of the committee continued:

"In the past it has not been uncommon, especially in the case of corporations formed to develop a new mine, to charge the par value of the stock issued to property account and to credit to surplus the cash received from the sale by the corporation of the stock donated to it. It is clear, however, that such a procedure results in an overstatement of the property account and of the surplus account.

"During the year, a registration statement in which this procedure had been followed was disapproved by the federal trade commission, and the committee believes that the Institute should also indicate its disapproval. Your committee, therefore, recommends that the following rulings on this point should receive the formal approval of the Institute:

> "If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.

"Your committee believes that members of the Institute should recognize an obligation, in any case in which they are called upon to prescribe or pass upon the treatment of capital stock donated to a corporation, to satisfy themselves that the transaction is a gift in good faith and is not an artificial or unsubstantial transaction designed to create an improper credit to surplus."

We are glad to report that these recommendations received the unanimous approval of the council. The evils which have arisen in the past from improper treatment of the exchange of capital stock for property and in the treatment of donated or redonated stock have been largely due to adherence to tradition, which had nothing to recommend it except a desire to present an appearance of prosperity when in fact operations had not yet revealed the probable fate of the issuing corporation.

American Institute of Accountants' Examinations

[Following is the text of the examinations in auditing, law and accounting presented by the board of examiners of the American Institute of Accountants, November 15 and 16, 1934.]

BOARD OF EXAMINERS

Examination in Auditing

November 15, 1934, 9 a. m. to 12:30 p. m.

The candidate must answer all the following questions:

No. 1 (5 points):

(a) State how a straight voucher system is used, recorded and controlled.

(b) May it be used in conjunction with an accounts-payable ledger, and in what way?

(c) Under what conditions is it preferable in conjunction with an accounts-payable ledger?

No. 2 (10 points):

In the annual audit of the firm of John Doe & Co. you find it has sold a substantial part of its accounts receivable to the X Discount Co., receiving an advance of 60% of their face value, the balance to be received when and as the accounts are collected from customers.

The advance was credited to the account of The X Co. when received, but in closing its books for the year the firm has deducted it from the total accounts-receivable balance on the theory that the accounts sold no longer belong to the firm and that the 40% equity in them is due from the purchaser.

You are requested to certify the resulting balance-sheet in this form without mentioning the sale of the accounts, if possible.

(a) Analyze the above transaction, and

(b) State three methods from which you could choose in order to give a certificate, qualified or unqualified.

(c) Which method would you adopt? Give your reasons.

No. 3 (5 points):

You are employed by the firm of Smith & Jones to close its books and prepare a balance-sheet, profit-and-loss statement, and federal income-tax returns for the firm and for each partner. You are not to audit the books. Neither partner keeps private books but each gives you memoranda of his "other" income and allowable deductions and credits.

With the usual income-tax forms you find additional ones which prescribe:

(1) That the taxpayers must state the fact if they employed anyone, and if so whom, to prepare or advise in the preparation of the return, and to what extent such assistance or advice was received: and

(2) That the person giving such service must make affidavit as follows:

> "I, acting as (advisor or attorney) for the hereto subscribed taxpayer affirm that I prepared the return, that the information set out in the return and accompanying schedules, if any, correctly and truly represents the information furnished or discovered by me during the course of preparation of the return, and that such information is true to the best of my knowledge and belief."

(a) How would you word the taxpayers' statements on these forms in the above cases?

(b) As a certified public accountant with all the responsibilities the title implies, what would you do to protect yourself in respect to the affidavit? Give your reasons.

No. 4 (15 points):

In the course of your audit of the X Machine Corporation for the year 1933 you discover that the plant account has been written down one-half its book value by the journal entry—

"Dec. 31, 1933.	Reserve for depreciation....	\$........	
	To plant account..................		\$........"

You learn that this was authorized by the board of directors, and you are shown a draft of the proposed report to stockholders in which it is recited that the amount represents the net book value, as of January 1, 1933, of plant and equipment which was idle during the entire year; that its purpose is to show the investment in plant at a conservative figure in accord with general conditions due to the depression; that its effect is to confine the annual depreciation charge to plant actually engaged in production during the year; and that the profit-and-loss statement thus shows the true profit made on actual production and sales. It is further intimated in somewhat guarded language that when and as business improves and the idle plant resumes normal production, the value now charged off will be restored to plant account.

State whether or not you will approve this procedure by certifying the corporation's statements, and give your reasons in full.

No. 5 (5 points):

How should the executor of an estate charge the following items as between corpus and income?

1. Physician's fees for last illness.
2. Funeral expenses.
3. Expenses of probating will.
4. General expenses of executor.
5. Loss on sale of investment.
6. Legal fees for collection of rents.
7. Legal fees for defending claims against the estate.
8. Executor's commissions.
9. Repairs to office buildings.
10. Estate and inheritance taxes.
11. Fire-insurance premium.
12. Special assessments adding permanent value to real estate.
13. Monthly allowances to beneficiaries.
14. Expenses incident to a change in executor.

No. 6 (20 points):

Give the program you would follow in making a balance-sheet audit of a small trading corporation.

No. 7 (10 points):

Brown, Smith & Jones, a firm, decide to dissolve partnership and to liquidate the business. Lacking confidence in each other, the partners employ you to conduct the liquidation and to determine the correct amounts due from or to each partner.

Describe in detail the steps you will take.

No. 8 (10 points):

You are making an audit of the X Corporation, among whose assets you find stocks and bonds of the Y Company of a substantial amount. In support of their value you are offered a balance-sheet of the Y Company certified by a fellow member of the American Institute. After careful study of this balance-sheet you are convinced there are serious errors in it and you can not conscientiously accept it. You explain the matter and point out the doubtful items to the officers of the X Corporation, whereupon, after securing the consent of the Y Company, they instruct you to make an audit of the Y Company also.

Bearing in mind the provision in the Institute's rules of professional conduct—that no member shall encroach upon the business of another member—what will you do? Give your reasons. Also state your understanding of the meaning of this provision of the rules.

No. 9 (10 points):

You are engaged in auditing the accounts of the American Manufacturing Company, a small corporation, the president owning approximately 96% of the outstanding capital stock. The company had been exceedingly profitable for a number of years and had invested some of its profits in good marketable securities so that funds would be available for an addition to its plant. Examining the securities you find in place of $25,000 par value of bonds, carried on the books at $20,000, a demand note for $20,000 signed by the president. The minutes of the board of directors show that these securities were lent to the president for his use as collateral to secure some personal transactions which have no relation to the affairs of the corporation. The securities are held by the Manufacturers' National Bank as collateral for the president's personal note, and you have received the bank's confirmation.

How will you show this condition in the balance-sheet and how will you qualify your certificate?

No. 10 (10 points):

You are to audit the accounts of the Kaslek Manufacturing Company at December 31, 1933, and your certified balance-sheet is to be used for credit purposes. On December 28, 1933, the corporation sold a piece of idle property, the terms of sale being one third cash, one third in a note due in 30 days and one third in a note due in 60 days. The price was determined by outside appraisal of October 15, 1933, and your investigation revealed that the transaction was apparently regular in every way. There were the proper resolutions in the minutes and all the necessary documents were produced for inspection. You also find that the cash had been duly deposited. You discover, however, that the purchasing company is controlled by a stockholder of your client, and you suspect that the transaction took place for the purpose of window dressing. On the date of your examination the first note is unpaid and the second note is not yet due. It more than doubled the current assets and therefore greatly improved the current asset position.

How will you deal with these facts in the balance-sheet and certificate?

Examination in Accounting Theory and Practice

PART I

NOVEMBER 15, 1934, 1:30 P. M. TO 6:30 P. M.

Solve all problems

No. 1 (25 points):

On January 1, 1933, the F Company purchased 90% of the stock of company G and 80% of the stock of company H. Wishing to acquire the remaining stock of the more profitable company (company H) company F on June 30, 1933, disposed of 200 shares of its holdings in company G at a price of $160 per share, and on that date was successful in acquiring an additional 10% of the stock of company H in exchange for the entire proceeds of the sale of company G stock.

The investment accounts on the books of company F are carried at cost except the account representing the investment in capital stock of company G: this account has been credited with the proceeds of the 200 shares sold.

From the following post-closing trial balances of the three companies at December 31, 1933, prepare:

1. A consolidated balance-sheet
2. A statement of consolidated earned surplus
3. A statement of goodwill

Assets	F	G	H
Current assets	$152,500	$150,000	$105,000
Investment in subsidiary companies—			
Company G:			
Capital stock	220,000		
Advances	25,000		
Company H:			
Capital stock	214,000		
Advances	40,000		
Buildings and equipment		170,000	235,000
	$651,500	$320,000	$340,000
Liabilities			
Capital stock:			
Company F—3,000 shares	$300,000		
Company G—2,000 shares		$200,000	
Company H—1,000 shares			$100,000
Due to parent company		25,000	40,000
Accounts payable	235,000	40,000	25,000
Surplus at beginning of year	166,500	60,000	145,000

Profit for the year	*$ 20,000	$ 15,000	$ 40,000
Dividends (paid Dec. 31, 1933)	*70,000*	*20,000*	*10,000*
	$651,500	$320,000	$340,000

* Dividends received from subsidiary companies, less expenses of parent company.
It is assumed that the profits of the companies for the year 1933 were divided equally between the two six months periods.

No. 2 (20 points):

John Jones set up an irrevocable trust for the benefit of his eldest daughter, Joan Jones, to run until 1935, when she would be thirty years old and would receive the principal of the estate outright. If she should die before attaining the age of thirty, the trust would go to her younger sister, Ethel Jones. The net income of the trust could be withdrawn by the beneficiary at any time.

By the terms of the trust agreement John Jones was to be trustee during his life and was to receive a fee of $1,000 a year in lieu of commissions.

Any investments made for the trust were to be subject to the approval of the trustee only and not to be bound by any legal rulings regarding trust investments.

There was paid into the trust by gift from John Jones on January 1, 1921, the sum of $100,000 which was to be invested by the trustee.

On December 31, 1930, Joan died and bequeathed her entire estate to her brother Paul Jones to be held in trust for him. He was to receive the income and had the right of appointment of the principal. John Jones was made trustee and was to receive an annual fee of $1,000 instead of commissions.

The trial balance of John Jones, trustee, at December 31, 1930 was as follows:

Debits	
Cash—principal	$ 7,000
Cash—income	9,550
$300,000 par bonds 4% R. R. & I. due 1955 at cost, investment of principal	275,000
Stocks—2,000 shares of $100 each at cost, investment of undistributed income funds	150,000
Oil Venture Syndicate—investment of undistributed income funds	12,500
Accrued interest on bonds	950
Payments to beneficiary from income during 1930	2,500
Expenses applicable to income for year 1930	1,850
Expenses applicable to principal paid during 1930	1,250
Trustees' fees for year 1930	1,000
	$461,600

Credits

Principal of trust—balance January 1, 1930	$275,000
Undistributed income balance January 1, 1930	138,500
Interest on bonds	12,800
Dividends	14,000
Profits on sale of principal investment bonds	9,200
Profits on stocks sold	9,600
Due trustee for fees	2,500
	$461,600

Analysis of undistributed income at January 1, 1930:	
Interest received	$ 80,000
Dividends received	89,000
Profits on stocks sold	30,000
	$199,000
Expenses charged to income	$ 16,500
Fees to trustee	9,000
Payments to beneficiary	35,000
	$ 60,500
Balance December 31, 1930	$138,500

Analysis of principal at January 1, 1930:	
January 1, 1921	$100,000
Increase to principal through sale of investments	190,000
Total	$290,000
Payment of expenses applicable to principal	15,000
Balance December 31, 1930	$275,000

During the three years ended December 31, 1933, the following transactions took place:

On December 31, 1931, the Oil Venture Syndicate was liquidated by receiving (a) 1000 shares no-par-value stock of the Oklahoma Oil Producers, Incorporated, of which the market value at December 31, 1931, was $10 a share; (b) $6,250 in cash; and (c) $12,500 5% Stanton Oils of California bonds due in 1955 of which the market value at December 31, 1931, was 80.

During the year 1932 the trustee sold $150,000 par value of the 4% R. R. & I. bonds at a net profit of $25,000 and invested the money in U. S. government 3¾% bonds at 100 net.

During 1932 the trustee invested $10,000 of undistributed income funds of the Paul Jones trust in Standard Oil of New Jersey at $40 per share, receiving 250 shares; the expense of the purchase amounted to $50.

On January 25, 1933, the trustee sold $12,500 par value bonds of Stanton Oils of California for $12,500 net and invested the proceeds in Tulsa city 4% bonds at 100 net.

During the three years ended December 31, 1933, there was collected:

Interest on R. R. & I. bonds	$26,321.25
Interest on Stanton Oils of California	625.00
Interest on U. S. government bonds	10,053.75
Interest on Tulsa city bonds	500.00
Dividends on stocks	40,000.00

During the same three years there was disbursed:

Payments to Ethel Jones as beneficiary	$ 6,000.00
Payments to Paul Jones as beneficiary	10,000.00
Expenses paid chargeable to income of the principal trust	4,000.00
Expenses paid chargeable to income of the undistributed income trust	3,500.00
Fees paid trustee	3,000.00
The account payable to trustee at Jan. 1, 1931, was liquidated	

No legal accounting was filed by the trustee during the whole period of the trusts.

Prepare statements from which the trustee may file this legal accounting. Disregard all taxes.

No. 3 (20 points):

The "A" Telephone Company was incorporated on January 1, 1931, for the purpose of acquiring and holding securities of companies operating telephone systems. The authorized capital stock consisted of 2,500 shares of $6 cumulative preferred stock without par value and 3,000 shares of common stock without par value. The authorized funded debt was $500,000. On January 1, 1934, three years later, the company voluntarily filed a petition in bankruptcy. An attorney for the bondholders' committee has asked you to examine the accounts and records of the company to determine why it was necessary to file such a petition when it had a surplus of $361,500 as shown by the following analysis of the company's surplus account:

Analysis of surplus account
January 1, 1931, to December 31, 1933

Date				Debit	Credit
1- 1-31	Excess of consideration paid in by shareholders, for shares having no par value, over the amount allotted to stated capital, as follows:				$285,000
	Cash paid in by shareholders		$500,000		
	Capital stock issue:				
	2,000 shares $6 dividend, no par, preferred stock, stated value $100 per share	$200,000			

	3,000 shares no par common stock, stated value $5 per share.......	$15,000	$215,000		
	Excess consideration paid in....		$285,000		
1- 1-31	Discount on purchase of 5,000 shares (total authorized) "B" Telephone Company common stock, par value $100 per share. The company entered this stock in its investment account at par, $500,000				$ 10,000
7- 1-31	Discount on sale of $500,000 par value "A" Telephone Company 6% ten year debenture bonds, dated 7-1-31................			$50,000	
12-31-31	Net profit from operations for the year ended December 31, 1931, (includes $50,000 undistributed profit for the same year, of the "B" company which was taken into earnings by charging that company's current account)............................				20,000
12-31-31	Dividends declared on preferred stock for the year ended December 31, 1931...........			12,000	
12-31-31	Dividends waived by shareholders owning 500 shares of preferred stock.............				3,000
1- 1-32	Discount on purchase of $400,000 par value "C" Telephone Company 5%, twenty year, sinking fund gold bonds, dated January 1, 1922................................				20,000
6-30-32	Unrealized profit from the exchange of "B" Telephone Company's common stock for 6,000 shares (total authorized) "C" Telephone Company common stock without par value. The latter stock was taken into the investment account at the stated value thereof, namely, $600,000..............				100,000
6-30-32	Discount on sale of 500 shares of "A" Telephone Company $6 cumulative preferred stock, stated value $100 per share........			5,000	
12-31-32	Net profit from operations for the year ended December 31, 1932, (includes $20,000 undistributed profit for the six months ended December 31, 1932, of the "C" Telephone Company which was taken into earnings by charging that company's current account)............................				10,000
12-31-32	Dividends declared on preferred stock for the year ended December 31, 1932...........			13,500	
1- 1-33	Discount on purchase of 600 shares of the company's preferred stock. This stock was canceled.........................				9,000
12-31-33	Net loss from operations for the year ended December 31, 1933....................			15,000	
				$95,500	$457,000
					95,500
	Balance December 31, 1933...............				$361,500

The articles of incorporation authorize the directors to purchase preferred capital stock which is to be retired from earned surplus.

At the date of filing the petition in bankruptcy, the total investments owned by the company consisted of the 6,000 shares of "C" Telephone Company's common stock and $5,000 par value, United States Treasury bonds. The latter bonds were purchased at par. The "C" Telephone Company went into the hands of a receiver on July 31, 1933.

From the foregoing data prepare an adjusted analysis of surplus account. Comment briefly upon any additional facts which you feel will be of value to your client.

No. 4 (15 points):

On April 1, 1929, a company sold $500,000 of its first-mortgage bonds at 90. The bonds matured to the amount of $50,000 on each of the next ten anniversaries of the date of issue. Those due in 1930 were paid; those due in 1931 were not paid but by agreement with the holders were extended for one year. During 1930 the company borrowed from its officers 1,250 shares of its own capital stock of a par value of $100 each (out of 1,300 shares outstanding) and obtained a bank loan of $100,000 with these borrowed shares as collateral. Interest was paid on this loan and on the bonds, but the bond maturities in 1932 were not met. The officers resigned and were replaced by executives approved by the creditors. The collateral to the bank loan was offered for sale at public auction and bought in by the bank for $20,000, which was applied in reduction of the loan. Thereafter the new officers of the company, in their personal and private capacities, entered into an agreement with the bank, which contained the following provisions:

(1) The bank agreed to sell and the officers to buy the 1,250 shares of stock for $20,000 payable at the rate of $500 per month plus interest, beginning January 1, 1933.

(2) The officers agreed to seek a five-year extension of the maturities on all bonds which by their face were due on or after April 1, 1933; these efforts were made and proved successful before that date arrived.

(3) The bank agreed to (and did) acquire all of the bonds which had matured on April 1, 1932, and agreed further that it would not exercise any of its rights to enforce collection of either these past-due bonds or of the now unsecured loan so long as (a) the officers were not in default on their stock-purchase obligations and (b) interest on

the past-due bonds and the unsecured loan was paid currently; provided, however, that the company made quarterly payments, to apply on the principal of the past-due bonds and unsecured notes, equal to as many multiples of $5,000 as might be paid from the sum of its net income and the net accretion to its depreciation reserve, computation of these amounts to begin as at April 1, 1933, and to be cumulative, and payment to be made within thirty days after the close of each quarter.

During its fiscal year ended March 31, 1934, the company's net income before depreciation was respectively $8,000, $16,000, $14,000, and $12,500 for the first, second, third and fourth quarters; expenditures for replacements charged against its depreciation reserve were respectively $4,500 and $6,000 for the first and second quarters. All interest obligations were met and payments to apply on the principal of past-due bonds and on the unsecured loan were made in accordance with the agreement outlined above. At March 31, 1934, the company's only indebtedness other than that discussed herein consisted of audited vouchers for current purchases and expenses amounting to $35,000, including interest due April 1, 1934, and its surplus was $67,500.

1. Prepare a statement showing the liabilities side of the company's balance-sheet at March 31, 1934, in such form as in your opinion would merit an unqualified certificate.

2. Explain any changes which you would make in that statement if the company had been a party to the agreement outlined above.

3. Explain how the amortization of the cost of floating the bond issue in 1929 would be affected by the extension secured in 1933.

No. 5 (10 points):

Adams and Bede commence in business in copartnership on January 1, 1930. Adams contributes $40,000 as capital and Bede $25,000. It is agreed that profits will be divided in the proportions of ⅔ to Adams and ⅓ to Bede and that 6% interest per annum will be credited on the original capitals. No interest is to be charged on drawings or credited on any excess of interest and profits over drawings. During the term of the partnership Adams' drawings amount each year to $10,000 and Bede's to $7,500. At the close of business on December 31, 1932, Bede retires from the firm and is paid from partnership funds the balance standing to the credit of his capital account. The net profits of the partnership were proportionate to the sales which for the three years ended December 31, 1932, respectively amounted to $250,000, $200,000 and $175,000. Adams will continue the business as a sole trader and at the commencement of business on January 1, 1933, prepares the following statement from the books:

Cash	$ 10,203.16
Accounts receivable	16,813.87
Inventories	24,311.97
Prepaid expenses	250.00
Fixed assets	40,000.00
Goodwill	15,000.00
	$106,579.00
Accounts payable	$ 24,861.05
Notes payable	15,000.00
Accrued liabilities	750.00
Reserves:	
For bad debts	2,500.00
Depreciation	12,000.00
	55,111.05
Capital	51,467.95
	$106,579.00

Prepare a statement of the partners' capital accounts for the three years ended December 31, 1932.

No. 6 (5 points):

A and B were partners under an agreement that the profits were to be equally divided and that A was to furnish one fourth and B three fourths of the capital actually used during each calendar year, interest at 6% per annum to be charged or credited on any differences.

Examine the following transcripts of their capital accounts and ascertain whether or not the entries at the end of the year were correctly made.

A—Capital

	Debits			Credits	
Sept. 1, 1933	Withdrawal	$3,000	Jan. 1, 1933		$10,000
Dec. 31	Interest on above for 4 months	60	Dec. 31	P. & L.	4,400

B—Capital

	Debits			Credits	
July 1, 1933	Withdrawal	$2,000	Jan. 1, 1933		$30,000
Dec. 31	Interest on above for 6 months	60	Dec. 31	P. & L.	4,400

No. 7 (5 points):

The Theatre Company rented films from the Film Company and agreed to pay as rental 15% of the Theatre Company's gross receipts up to a point where it earned a profit (before deducting the rental) equal to one-half of the total rental and beyond that point at the rate of 50% of the gross receipts.

Calculate the film rental for a period in which the gross receipts amounted to $1,000 and the expenses (other than rental) amounted to $400.

Examination in Commercial Law

November 16, 1934, 9 A. M. to 12.30 P. M.

Reasons must be stated for each answer. Whenever practicable, give the answer first and then state reasons. Answers will be graded according to the applicant's evident knowledge of the legal principles involved in the question rather than on his conclusions.

Group I

Answer all questions in this group.

No. 1 (10 points):

Backus, in the excitement of a railroad accident, lost unregistered coupon bonds and stock certificates endorsed in blank which he had been carrying in a brief case. These were found by another passenger who made no attempt to ascertain or find the loser but two weeks later sold the bonds and the certificates. The purchaser paid full value for them and had no knowledge of Backus' loss. Did the purchaser become the legal owner of the bonds and the certificates?

No. 2 (10 points):

Andrews was appointed trustee of certain real property by a written instrument which specified that the income was to be paid to a named beneficiary during the latter's life and that title to the property was to be conveyed to another beneficiary upon the death of the life-tenant. What duties, if any, may Andrews delegate to assistants or agents?

No. 3 (10 points):

(a) Define "ultra vires" as used in the law with respect to corporations.

(b) Give an example of an ultra-vires act.

No. 4 (10 points):

Watson and Titus were partners, under a partnership agreement which made no mention of the death of either. Watson by his will bequeathed his interest in the partnership to his wife. Upon Watson's death, did his wife become a partner with Titus by virtue of this legacy in Watson's will?

No. 5 (10 points):

Davis borrowed money from Harrison and gave him as security a power of attorney to collect future rents from Davis' tenants.

(a) Would this power of attorney be canceled by Davis' death prior to the repayment of the loan?

(b) Can a tenant who knows of Davis' death discharge his obligation for rent accrued prior thereto by paying Harrison?

Group II

Answer any five questions in this group. No credit will be given for additional answers, and if additional answers are submitted only the first five will be considered.

No. 6 (10 points):

Kenyon was a business man in the city of X. He signed a subscription list by which he agreed to contribute $1,000 towards the purchase of a building for the local chamber of commerce. Other subscribers for the same amount signed this list both before and after Kenyon signed it and Kenyon knew of these other subscriptions. The building was purchased in accordance with and in reliance upon this subscription list. Can Kenyon be compelled to pay the amount of his subscription?

No. 7 (10 points):

Define and explain briefly (a) patents, (b) copyrights and (c) trademarks.

No. 8 (10 points):

A drawee of a draft, in answer to an inquiry by the payee, wrote that he would honor a draft for $1,000 by Samuel Thompson. A draft on this drawee by Samuel Thompson for $1,000 was duly presented but acceptance was refused because the words "with exchange" had been added. Can the payee collect from the drawee?

No. 9 (10 points):

Define "common law" and briefly differentiate it from statutory law.

No. 10 (10 points):

In a state where gambling is and always was unlawful, Olsen owes Marks a gambling debt and Marks engages Shepard to collect it on a 25% fee. Shepard collects the amount of the debt but refuses to transmit any part of it to Marks. Can Marks recover in an action against Shepard?

No. 11 (10 points):

Define "stoppage in transit," state who may exercise this right, and in general when the right ceases to exist.

No. 12 (10 points):

Emerson rented a furnished apartment containing a radio connected with receiving wires on the roof of the apartment house (with which radios in other apartments also were connected). Emerson removed this radio and substituted one of his own without injury to the connecting wires. At the termination of his lease he removed his own radio and reconnected the landlord's. The landlord claimed both radios. On what principle of law was this claim based? Should the landlord's contention be sustained?

Examination in Accounting Theory and Practice

PART II

NOVEMBER 16, 1934, 1:30 P. M. TO 6:30 P. M.

Solve all problems

No. 1 (30 points):

On December 31, 1928, the Star Drug Company with an outstanding capital of $500,000, the Mormon Drug Company with an outstanding capital of $400,000 and the Gulf Drug Company with an outstanding capital of $450,000—all shares of $100 each—merged into one operating company known as Continental, Inc. with a capital stock issue of 1,350,000 shares of no par value.

The stockholders of the three merging companies received the

1,350,000 shares in return for their aggregate holdings of $1,350,000 par, i.e. 100 shares of Continental, Inc. for each share of the merging companies. On the above date Continental, Inc. also took over all the assets and liabilities of the three companies. Their individual charters were, however, kept alive.

On December 31, 1933, five years later, the balance-sheet of Continental, Inc. was:

Assets		
Cash		$ 150,000
Accounts receivable		
Star Drug Co. customers	$ 125,000	
Mormon Drug Co. customers	100,000	
Gulf Drug Co. customers	70,000	295,000
Inventory:		
Star Drug Co. products, materials, etc.	140,000	
Mormon Drug Co. products, materials, etc.	120,000	
Gulf Drug Co. products, materials, etc.	115,000	375,000
Plant and equipment at present values appraised on December 31, 1933—		
Star Drug Co. plant	1,500,000	
Mormon Drug Co. plant	1,300,000	
Gulf Drug Co. plant	1,000,000	3,800,000
		$4,620,000
Liabilities		
Accounts payable		$ 89,000
Bonds of subsidiary companies		
Star Drug Company	$1,197,400	
Mormon Drug Company	783,160	
Gulf Drug Company	519,440	2,500,000
Capital stock outstanding		785,000
Surplus		1,246,000
		$4,620,000

At December 31, 1933, Continental, Inc.'s stockholders decided to decentralize and restore to each of the original companies its proportion of assets and liabilities. The net worth was to be prorated on the basis of each company's capital investment on December 31, 1928, and it was found that the Star Drug Company was to receive 40%, the Mormon Drug Company 36% and the Gulf Drug Company 24%.

On December 31, 1928, the three merging companies owned each other's stock as follows:

The Star Drug Company owned—	
1,200 shares Mormon Drug Co., cost	$ 100,000
2,500 shares Gulf Drug Co., cost	200,000

The Mormon Drug Company owned—	
1,000 shares Gulf Drug Co., cost	$ 75,000
500 shares Star Drug Co., cost	50,000
The Gulf Drug Company owned—	
50 shares Mormon Drug Co., cost	10,000
400 shares Star Drug Co., cost	30,000

A summary of Continental, Inc.'s surplus shows:

Surplus of merging companies—December 31, 1928	
Star Drug Company	$ 190,000
Mormon Drug Company	375,000
Gulf Drug Company	81,000
Excess of par over book value of intercompany holdings	100,000
Earnings of five years	892,500
	$1,638,500
Less—Dividends paid	392,500
Balance, December 31, 1933	$1,246,000

It was decided that in the redistribution each of the three companies would receive a proportionate share of the cash; its own accounts receivable and inventory; its original investments in the other companies at original cost to itself and its own plant and equipment. On the other hand, each would assume a proportionate share of the current liabilities but would become wholly liable for its own outstanding bonds. All differences were to be charged or credited to current account for future settlement.

From the foregoing data prepare:

1. A statement showing in columnar form the balance-sheets of the three drug companies after decentralization on December 31, 1933.
2. A statement showing that the adopted ratio 40: 36: 24 approximately agrees with the proportions existing on December 31, 1928.

No. 2 (20 points):

The following accounts covering the year 1933 are submitted by The Electric Company which sells and installs electric alarm systems for banks and other institutions:

Balance-sheet—December 31, 1933

Assets

Current assets:		
Cash	$ 25,000	
Accounts receivable	237,500	
Inventories	53,000	
Unbilled contracts	38,000	$353,500

Fixed assets:		
Factory equipment	$164,000	
Less: reserve for depreciation	33,000	$131,000
Patents, less amortization		75,000
Prepaid insurance, commissions, etc.		13,500
		$573,000

Liabilities

Current liabilities:		
Accounts payable	$ 80,800	
Salesmen's commissions	9,500	
Accrued wages	2,700	$ 93,000
Capital stock:		
Six per cent. preferred	$200,000	
Common	50,000	250,000
Earned surplus:		
Balance, January 1st	$102,000	
Net profit for 1933	140,000	
	$242,000	
Less: preferred dividends paid	12,000	230,000
		$573,000

Profit-and-loss statement
Year ended December 31, 1933

Income from contracts:		
Installation contracts	$313,000	
Repair service	30,000	
Inspection contracts	50,000	$393,000
Cost of contracts:		
Materials, labor and factory overhead:		
Installation contracts	$131,250	
Repair service	20,000	
Inspection contracts	10,000	161,250
Gross profit on contracts		$231,750
Selling expenses	$ 60,000	
General and administrative expenses	38,750	98,750
		$133,000
Other income		7,000
Net profit for year		$140,000

Additional information is procured as follows:

1. Accounts receivable segregation:

Completed contracts—current	$110,000
Completed contracts—due July 1, 1935	25,000
Due from officers and employees—current	7,000
Uncompleted installation contracts—billed	75,000
Overdrawn salesmen's accounts	2,000
Stockholders' subscription, represented by demand note receivable, dated March 1, 1928	7,500
Contract balance, past due, secured by customer bank stock, face value $12,000 not marketable	11,000
	$237,500

2. Preferred dividend for half year ended December 31, 1933, declared December 15, 1933, payable January 15, 1934.	
3. Installation contracts are not collectible until completed.	
4. The cost of installation contracts equals 50% of the installation contract income.	
5. Uncompleted installation contracts (billed in 1932), one-half completed at December 31, 1932	$ 75,000
6. Uncompleted installation contracts, one-third completed at December 31, 1933 and fully billed to customers	75,000
7. Unbilled contracts, no work thereon at December 31, 1933	38,000
8. Inspection service contracts are billed annually in advance, the charges being of uniform amount each month. The billings in 1932 were the same as in 1933.	
9. Federal and state taxes are estimated to equal 17½% of the net profits. The change in the method of accruing income need not be considered.	

Prepare the adjusted balance-sheet and profit-and-loss account, also a surplus account showing the adjustments thereto.

No. 3 (10 points):

A corporation presents the following condensed statement as of the close of the year:

Cash	$ 90,000	Dividends payable	$ ....
Other assets	1,510,000	Other liabilities	500,000
		Common stock	500,000
		6% preferred stock	300,000
		8% preferred stock	200,000
		Surplus	100,000
	$1,600,000		$1,600,000

The 6% stock is cumulative, the 8% stock is non-cumulative, and both participate equally in the remaining surplus profits by being entitled to an extra dividend equal to the excess of any common dividend rate over and above 6% per annum.

A. Compute the book value per share for each class of stock in the following cases:

1. Current year's dividends unpaid.
2. Dividends unpaid for two years.
3. Dividends unpaid for three years.

B. What dividends could legally be declared to the various classes of stockholders, assuming that the 6% stock is non-participating, the 8% stock is participating on the basis stated and no dividends are in arrears?

No. 4 (10 points):

At a given date the condensed balance-sheets of two firebrick companies were as follows:

Alpha Firebrick Co.

Fixed assets, at cost less depreciation........	$1,800,000	Capital stock: Authorized—12,000 shs. Issued—8,000 shs....	$ 800,000
Current assets........	867,000	Liabilities............	620,000
Goodwill.............	None	Surplus..............	1,247,000
	$2,667,000		$2,667,000

Beta Firebrick Co.

Land at cost..........	$ 277,000	Capital stock.........	$ 500,000
Buildings at cost, less depreciation........	50,000	Liabilities............	120,000
Equipment, at cost less depreciation........	100,000	Surplus..............	257,000
Current assets........	100,000		
Goodwill.............	350,000		
	$ 877,000		$ 877,000

Alpha Company then bought all the assets of Beta Company, giving in payment $400,000 of its own stock. This purchase price included payment at book value for buildings, equipment and current assets, the balance being payment for the land. The latter contained a deposit of fireclay estimated at 12,000,000 tons, which was the primary reason inducing Alpha Company to acquire the properties. It was estimated that when the clay deposit was exhausted the residual land would be worth not more than $10,000 and the equipment and buildings would be worth nothing. The goodwill on the books of Beta Company had been set up in the early post-war years by a credit to surplus, in an attempt to set up a large investment for purposes of excess-profits tax.

How should the properties be taken up by Alpha Corporation and what charges to profit and loss should be made thereafter in respect to depletion, depreciation and obsolescence, assuming (1) that the buildings would outlast the clay deposit and that the equipment would be sufficiently provided for by an annual provision of 10% of the cost to Alpha Company. Use straight-line rates, on per ton or time basis, as you think proper. Give reasons for what you do.

No. 5 (5 points):

K Company holds a first mortgage of $25,000 and L Company a second mortgage of $10,000 on real estate of M Company.

M Company has defaulted in payment of one year's interest of $1,500 on the K Company mortgage and assigns future rents to K Company authorizing the latter to manage the property as mortgagee in possession.

Six months later L Company institutes foreclosure proceedings and pending final sale thereunder the K Company is appointed by the court as receiver for rents.

How should the rents and expenses be treated in the books of K Company during (a) the first six months (b) the second six months? Give reasons.

No. 6 (5 points):

Your audit of the records of N, a bankrupt company, disclosed the following entries made one day before adjudication by the court.

a) Journal entry crediting the account receivable of O Company and debiting the account payable of O Company with $10,000 to offset accounts representing mutual dealings.

b) Cashbook entry applying entire bank balance of $25,000 in reduction of an unmatured note of $50,000 to the same bank.

c) The sale and delivery of all merchandise on hand at current market sales prices to P Company, holder of unmatured notes payable of the N Company which are personally endorsed by officers of the N Company. The merchandise is delivered in full and final settlement of these notes.

Comment upon these transactions.

No. 7 (5 points):

In 1929 T Company purchased a large factory building and, to finance the deal, executed a purchase-money mortgage of $100,000 payable in 10 years. In 1933 it sold the property to U Company which deducted from the sales price of $150,000 the amount due on the purchase-money mortgage of $100,000.

In the course of your examination of the books of T Company for the year ended December 31, 1934, you find a journal entry recording the sale of the property.

How should the realty transaction be shown on the balance-sheet, assuming that there is a marked deflation in realty values and that the U Company was declared bankrupt on December 1, 1934?

No. 8 (5 points):

The Island Syndicate offers to build a bridge across The Narrows at a cost of $20,000,000 and to accept in payment the city's 4% bonds, redeemable in 25 years, interest payable semi-annually. The annual maintenance charges are estimated at $50,000 a year. It is proposed to charge tolls—5 cents for foot passengers and 50 cents for vehicles. Based on these charges and assuming a ratio of foot passengers to vehicles of 1 to 20, how many tolls of each class would be necessary each year in order to provide for maintenance, interest and a sinking fund (earning the same rate of interest as the bonds) sufficient to retire the bonds at maturity? The amount of $1 after 50 interest periods is $2.692.

No. 9 (5 points):

On January 1, 1930, the V Company issued $1,000,000 bonds at 95. In terms of the issue $200,000 are to be retired on January 1, 1933, and $500,000 by annual amounts of $100,000 on January 1st of each of the five years next succeeding, the balance of $300,000 to be retired on January 1, 1939. Prepare a table showing the amortization of the discount by the bonds-outstanding method.

No. 10 (5 points):

In the course of your examination of the accounts of the Grander Company, Incorporated, you find that the company entered into certain irregular transactions. The company may be liable for damages as a consequence of the first of these transactions, while in the second it has performed a contract which is voidable by the other party who appears on the company's books as a debtor for the agreed contract price. In the third place certain ultra-vires transactions have been fully completed on both sides but others are still open, the company including in its book debts the amount due from the second party arising out of these transactions.

How would you deal with the foregoing transactions in your report?

Practice Under the Securities Act of 1933 and the Securities Exchange Act of 1934 *

By Rodney F. Starkey and A. I. Henderson

FROM THE VIEWPOINT OF THE ACCOUNTANT

BY RODNEY F. STARKEY

I have been asked to discuss the questions of practice under the securities act of 1933 and the securities exchange act of 1934.

So much has been written and said on the subject of the hazards and the burdens which have been laid upon business men by these acts that any discussion of the subject will of necessity be somewhat repetitious. However, I intend as nearly as may be to confine my discussion to two major topics: the particular aspects of the securities act of 1933 and the regulations issued thereunder which have made it excessively burdensome to prepare the accounting sections of registration statements and a brief outline of certain procedures which have been followed in making examinations for that purpose.

It is a bit premature at this time to attempt to go very far into a discussion of the question of practice under the securities exchange act. The new act appears to make it necessary for any person suing to prove reliance on the statements, which would tend to make the liability provisions as affecting accountants somewhat less onerous than under the securities act. As you know, only very tentative regulations have been issued for temporary registration of listed companies under this act. Under these regulations it would seem that after the listed companies have complied with the temporary registration requirements, any reports and financial statements made available to security holders and/or stock exchanges may be considered to have been filed pursuant to the securities exchange act, and those responsible may be considered subject to the liability provisions of section 18. It seems to me, therefore, that for all practical purposes the standard of care to be used in the preparation of any financial statements and such registration statements as later may be filed should be the same as that followed in the preparation of registration statements under the securities act.

*Addresses delivered at the annual meeting of the American Institute of Accountants, Chicago, Illinois, October 16, 1934.

A typical example of the results of the burdens imposed by the securities act and the regulations may be found in the registration statement, with the auditor's certificate, filed by the American Water Works and Electric Company, Incorporated, about seven months ago. This company was one of the first large companies to register its securities. A great deal was written at the time commenting on the fact that the auditor's certificate contained 1,350 words, that the registration statement had approximately 200 pages, that the prospectus consisted of 60 pages and that the complete set of documents filed with the registration statement, including all exhibits, ran into something like 1,800 pages. Incidentally, the cost of obtaining a copy of the registration statement alone, at the present rate per page for photostating, would be $40 and the cost of obtaining the complete registration statement with all documents would be $360. This appears to be a perfectly amazing document to offer the average investor for his protection and to allow him an opportunity to study the background of the company before he makes his investment. I am told, however, that another company which is now considering registration has estimated that the registration statement, the prospectus and all of the exhibits to be prepared and filed, if piled together, would be taller than the company's president.

Certainly these documents have not accomplished the purposes of the act. I am sure that the framers of the act were not so sanguine as to have hoped that the information could be furnished in such form as to be intelligible to the average investor. It was intended, no doubt, that the information compiled for registration statements would be available to analysts who would, in turn, be able to furnish investors with the salient features. Nevertheless, because of the extremely heavy penalties which the act placed on the issuer, its officers and the experts involved, not only for misleading statements, but for the omission of any material facts which might make the statements misleading, those who have been concerned with the preparation of such registration statements as have been filed have not felt that it was advisable to omit any of the details which have been given.

It has been the experience of my firm that notwithstanding the fact that we had been acting as regular auditors for all of our clients which have filed registration statements, and for a considerable period prior to the actual date of filing, it has taken us at least twice the amount of time to complete an examination of the balance-sheet and related statements for the purpose of registration as it previously had taken to make regular annual examinations.

This additional time and resultant expense has been caused primarily by the seemingly endless elaboration of detail and explanatory material which has been furnished in the registration statements, in the attempt to avoid the omission of material facts and also by the additional effort expended to check and cross-check the accuracy of the details which are required both by the act itself, either specifically or by implication, and by the regulations issued by the commission.

Undoubtedly the amendments made to the act this year will be helpful—more so, of course, to the directors and officers than to the experts—but the basic fault underlying both the securities and exchange acts is still existent: namely, the theory of rescission whereby a purchaser may recover heavy penalties for honest mistakes which might bear no direct relation to the causes of the loss. As long as this distorted theory of justice to investors remains in these acts it will be difficult to approach the task of preparing accounts for registration without undue trepidation at the hazards involved. Such a state of agitation can not but have a tendency to warp one's judgment and the result is bound to be the adoption of a super-cautious attitude. Also, while this condition continues, registration statements are apt to be exceedingly unwieldy documents and in the last analysis will tend to be more confusing and misleading to investors than most of the prospectuses which were issued before the enactment of this legislation.

There is no doubt that the new prospectuses issued under the securities act are very much more honest than the few really bad prospectuses which were issued before the act. However, to my mind, there is no question that they are not as satisfactory as the former good prospectuses. Prior to the enactment of the securities act great care was given to the choice of the important information for prospectuses; selection and emphasis were considered far more important than quantity. The former good prospectuses, so to speak, were put through a sieve, but this condition may be very difficult to develop under mandatory requirements. Incidentally, it is the opinion of the best lawyers who have studied the securities act that the investor will get more effective protection under section 12 of the act referring to prospectuses than he can ever expect to get under section 11, referring to registration statements.

These difficulties are not entirely questions of administration on the part of either the present securities and exchange commission or its predecessor, the securities division of the federal trade commission. The commissioners have a very difficult problem and from the experience I have had with them I can say without hesitation that they are approaching it in an entirely sympathetic attitude and with a real desire to be helpful to business men as well as to prospective investors. The commissioners recognize that the results have not been satisfactory and are determined to reduce to the greatest possible extent the bulkiness and unwieldiness of both registration statements and prospectuses.

The commission charged with the duty of administering both acts has been given very broad powers by these acts to prescribe the form of reports, the details to be shown in the balance-sheet and earnings statement, the methods to be followed in the preparation of reports, in the appraisal and valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income and investment and operating income, and such further information as may be necessary or appropriate for the proper protection of investors.

During the past few years all the larger stock exchanges in the country have been adopting more and more comprehensive rules designed to enhance and expand the amount of information which should be furnished to or made available to investors. In all these efforts accountants have coöperated to the full extent. A noteworthy example of the efforts of accountants in this direction is outlined in the bulletin sent in January, 1934, to all members of the American Institute of Accountants containing correspondence between the special committee on coöperation with stock exchanges of the Institute and the committee on stock list of the New York Stock Exchange. It is particularly of interest to note that the suggestions of the Institute's committee were promulgated in September, 1932, some time before the securities act had ever been drafted.

There is, however, one most important and fundamental distinction between these efforts at raising the standards to be followed in making reports to investors on the one hand by stock exchanges, business executives and professional accountants and on the other by compulsory regulation through the medium of a federal commission. A voluntary movement can always attain higher standards because of its flexibility. Regulation by an outside commission, however, no matter how intelligently and sympathetically administered, of necessity has a rigidity which must prove irksome, and, because of such rigidity, the standards set never can reach as high a plane of perfection as can the more flexible standards adopted and followed voluntarily without regulation. The first method is undoubtedly the more progressive and more satisfactory method. Self-government with a minimum of regulation will always be the ideal of an intelligent people.

Since the passage of the securities act a very large part of the criticism which has arisen has been levelled against the regulations promulgated by the federal trade commission for the administration of the act. Undoubtedly these regulations calling, as they do, for elaborate details of certain balance-sheet items have proved to be exceedingly burdensome for the few large companies which have attempted to register and particularly those which have been in business for a longer period of time.

For example—

The details of ledger value, cost, profits to affiliates, unrealized appreciation and other historical information required for all major classifications of property, plant and equipment from organization or, if not practicable, beginning January 1, 1922.

The comparison requested for the amounts of depreciation taken for financial purposes with the amounts claimed for federal income taxes for every year for which federal income tax returns have been filed.

The several schedules requiring cost and other statistical information for each investment, without specific limit of the period of time to be covered.

Similar historical statistical information required for the capital-stock and surplus accounts.

The result of these requirements has been that, although the financial statements originally were designed to be of assistance to investors, the balance-sheets, profit-and-loss statements and related schedules with the explanatory notes in several of the registration statements which have been filed for the larger companies have comprised approximately two-thirds of the total number of pages included in the registration statement. Furthermore, it is safe to say that at least 50 per cent. of the schedules furnished contained historical statistical information of no interest whatsoever to the layman, information that he could not possibly understand, but, because the information was included in the registration statement the issuer, its officers and directors and the experts jointly and severally are subject to the exceedingly heavy liability provisions of the act in the event that honest mistakes have been made in its compilation.

With reference to the requirements on details of fixed assets and investments, personally I believe there has been entirely too much stress laid on the values at which capital assets were stated in the accounts. This had led to the oftentimes vicious practice of stating book values of stocks being dealt in on the stock exchange as if these book values had a real significance. I am inclined to believe that a substantial part of the speculative losses of the last few years has been due to this unwarranted faith in that intangible something which asset values are supposed to represent.

It is very difficult, however, to determine exactly how much of this condition is the fault of the regulations and how much is the fault of the act itself. In schedule A of the act, items 25 and 26, balance-sheets are called for "showing all of the assets of the issuer, the nature and cost thereof whenever determinable, in such detail and in such form as the commission shall prescribe, and all liabilities of the issuer in such detail and such form as the commission shall prescribe, including surplus of the issuer showing how and from what sources such surplus was created." In addition, "a profit-and-loss statement showing earnings and income, the nature and source thereof and the expenses and fixed charges in such detail and such form as the commission shall prescribe." These provisions in the act have imposed on the commission a difficult and responsible task. It would be easy for them to play to the congressional gallery by taking the safe position and by insisting on more and more extensive details in registration statements; however, I am confident that the members of the commission realized that such an attitude would have a distinctly adverse effect on the economy of the country and that they are willing to take the responsibility of preparing regulations under the present acts which will impose as little burden on registering corporations as possible.

One of the most complicated practicable problems which the commission has to face is that all corporations are not homogeneous and that the regulations issued will have to be complied with by large and small, seasoned and unseasoned corporations and that between both extremes there lies a great variety of accounts. Generally speaking, there are three possible solutions to this difficulty. The commission can issue one set of forms so comprehensive in detail that all types of corporations can use it, albeit not satisfactorily. They can promulgate a variety of forms which would lead to endless confusion as to which form is adaptable for a specific company. Or they can publish their regulations on a basis of as much flexibility as is possible under the acts as they stand at the present time. This latter procedure, to my mind, would be the most eminently satisfactory one.

For many years accountants have been attempting to improve the standards of presentation of financial statements and the extent of disclosure to be contained in these statements. However, the theory of rescission which underlies both of the acts, with the consequent heavy liabilities incurred for misleading financial statements, has probably given a weight and a prominence to the presence of these statements which can not exist. One most important and practical aspect which will have to be faced in the preparation of registration statements is that the wrong inferences may be drawn by the uninformed investor. One of these inferences is that the most important factor underlying the success or failure of business enterprises rests in the correct preparation of accounts relating to the past history of these enterprises.

It is interesting to note that since the passage of the securities act, the preponderance of issues registered and presumably sold to the public has consisted of the most speculative enterprises, viz., financial and investment companies, mining companies, breweries, distilleries and other ventures of similar character. Such issues have furnished the larger part of the new investment material during the last year and a half. In all fairness it should be said that every effort has been made by the federal trade commission and by its successor in the administration of the two acts, the newly formed securities and exchange commission, to see that no one should be misled into believing that the government in any way intended to guarantee these speculative issues. Nevertheless, it seems to me that there is a great possibility that many of the small investors who have purchased such securities have done so with the feeling that in some way the securities have been accredited by the government of the United States.

This is a very real danger both to the government and to all the accountants who have participated in the preparation of registration statements; and this danger will continue. As accountants, therefore, we are vitally interested to see to it that a campaign of education of investors is undertaken so that the limitations adhering to financial statements for companies whose securities are admitted to registration by the commission will be more clearly understood.

One of the most radical changes brought about by the enactment of these two securities acts has been the complete abolition of the privity of contact between our profession and our immediate clients. Incidentally, this condition apparently has been aggravated by the amendments to the liability provisions of the securities act of 1933. By these amendments, officers, directors and others do not have to sustain the burden of proof affirmatively that they had reasonable grounds to believe and did believe that the statements were true and that there was no omission to state a material fact, but they need only show from the negative standpoint that they had no reasonable grounds to believe and did *not* believe that the statements were *untrue*, etc. According to several prominent attorneys this reversion to the negative attitude will serve to lessen to a great degree the responsibility of officers and directors, but it in no way relieves the expert, that is, the professional accountant, appraiser or engineer, except to the extent that one expert may rely on a report of another. This can only mean that regardless of the source of our instructions or regardless of the person responsible for our fees, our ultimate client is now the investor, and it is to him that we are directly responsible for our part in the presentation of accounts.

Aside from the preparation of the accounts themselves, the content of the accountant's report and the explanatory notes appended to the accounts are of great importance. The radical increase in responsibility which came with the passage of the securities act means that until a great many years have passed and there have been legal decisions rendered which shall have clarified a large number of questions surrounding the presentation of accounts, every accountant signing a registration statement will have to be ready to sustain the burden of proof as against any investor and to the satisfaction of the courts that he had complied with all the requirements laid upon him by the acts. This is going to make it necessary for the accountant to have available, at all times within the statutory period allowed by the acts, sufficient evidence to show that his examination was conducted properly, that the scope was as extensive as required by the acts and that in his report he discussed all the things which might have affected the judgment of the investor.

Because of the lack of precedent, it may be a rather difficult matter to sustain the burden of proof that an accountant's examination was as extensive as contemplated by the acts.

The first general effort undertaken by the profession to establish standards for accountants' examinations and the presentation of financial statements was made in 1917. At the suggestion of the federal trade commission, a committee of accountants and the federal reserve board issued the first bulletin *Verification of Financial Statements*. This bulletin was subsequently revised in 1929 and has remained unchanged since that time. In the preface and in the general instructions to this bulletin, its very definite limitations are clearly indicated, and it is stated that the procedure described is designed primarily for industrial and mercantile concerns. However, since this bulletin is the only outline of standard practice and procedure, in spite of its limitations, it would seem that the accountant charged with the necessity of sustaining the burden of proof that his investigation was a reasonable one at least should be in a position to show that his examination, generally speaking, was as extensive in scope as that contemplated by the bulletin.

Doubtless, there will always be a certain amount of controversy as to some of the procedures outlined in this bulletin. At the present time, however, it is the only document of its type in existence, and failure to comply with the suggestions contained in this bulletin might entail very serious consequences in the event that an accountant signing his report in connection with a registration was made party to a suit.

Even in the case of public-utility companies it is possible to go through this bulletin item by item, and with a very few exceptions the procedures suggested can be followed. The procedures and practices outlined in this bulletin are given as suggestions only and if the accountant finds it necessary to deviate in any material particular from these suggestions he should be able to explain the reasons for such deviations in his report or should have careful notes in his permanent files containing such explanations.

I believe that accountants may well profit by the example of many attorneys who keep a careful diary of each case, outlining from day to day all important discussions and questions raised and their ultimate disposition. Such a diary produced in court at some later date, if necessary, would certainly furnish the clearest and most convincing evidence of the care used in conducting the examination.

Recently the suggestion was made in a meeting with certain of the commissioners, which received immediate approval by all concerned, to the effect that there should be compiled a book of instructions, either gotten out by the commission itself directly or prepared with the assistance of accountants and sponsored by the commission; this set of instructions to take the place of the present bulletin *Verification of Financial Statements* for the specific purposes of the securities acts. Since the commission has such wide powers for administering these acts, the effect of such a book of instructions would be exceedingly helpful to our profession and would serve to a great extent to clarify for the future the procedures and practices which should be followed to constitute a reasonable investigation.

It is always a very difficult thing when faced with an entirely unmeasurable hazard to keep one's equilibrium. Five years hence the hazards of these acts which now loom up so fiercely to us, as professional men, may have proved to be entirely insignificant. As a relatively new profession in this rapidly changing world, however, we are now finding ourselves at an exceedingly crucial point.

I should like to offer the following practical suggestions for the preparation of registration statements. These suggestions to a very large extent constitute a résumé of advices from attorneys and others in connection with the preparation of registration statements which have been filed with the benefit of discussions with the examiners for the commission who review the statements.

Accountants' reports or certifications, as they are termed by the present regulations, may be expected to include three general types of comments on the accounts of registering companies: First, they should outline such matters as relate to the extent of the examination which, although not considered by the accountant as matters which should have been covered to make his examination a reasonable one, might be assumed by laymen or by the courts to have been covered. It is very often astonishing to find that people usually well informed have an entirely different conception of the extent of an accountant's examination from that contemplated by the accountant himself. Possibly, to a certain extent, this confusion has been enhanced by accountants; perhaps there has been too much of an air of mystery and obscurantism about the whole thing. In the circumstances, it would seem to be a policy of wisdom to see to it that the ordinary restrictions to the regular examinations are adequately commented on in the reports.

For instance, in spite of all of the controversy on the subject there is still a very definite confusion in the minds of a great many people as to the extent of the responsibility which an accountant can accept for the inventories at a given date. When we sign a certificate without qualification of inventory values, what we mean, of course, is, accepting the quantities and condition of the items inventoried, as vouched for by responsible officers, we have satisfied ourselves that the valuations of these items as applicable to a going concern, have been carefully and accurately made, in the aggregate, at approximate cost or on some other clearly described basis. My suggestion is that such a statement should be incorporated, where applicable, in the accountant's report.

There is also what seems to be an entirely unwarranted idea that accountants should accept definite responsibility for the valuation shown for plant assets and other fixed assets. Time and again financial writers have commented on this phase of accounting. Why should we not see to it that a clear description is given of the cost or other historical basis of valuation of such assets both in the accounts and in the certificate, and that this basis generally is not considered as subject to the fluctuations of current market quotations or price levels?—Assuming of course that this is the condition which we find.

The extent of verification of other items, such as accounts receivable, reserves for doubtful receivables, claims recoverable, contingent liabilities, etc., if not as extensive as that contemplated by the federal reserve bulletin would also be essential to a more clear understanding of the meaning of an accountant's certification. With respect to all items of this nature, it should be clearly indicated in the accounts that the amounts shown are stated on the basis of a going concern.

In the case of contingent liabilities, particularly, a definite statement as to procedure should be included. An example of this will be found in the description attached to the schedule "contingent liabilities" appearing in the certificate of the American Water Works and Electric Company, Incorporated. I quote this in part, "We have received a certificate from a vice-president, the treasurer and comptroller of the issuer to the effect that to the best of their knowledge and belief the issuer and its subsidiary companies had no material contingent liabilities at September 30, 1933, not mentioned in balance-sheet instructions No. 27 of the registration statement. The amounts shown as principal of bonds guaranteed by the issuer have been checked to documents furnished us by the issuer. All the other information in this schedule has been accepted by us, but without responsibility on our part."

In the second group of special comments which one would expect to encounter are matters in the accounts on which the accountant is not in a position to formulate a definite opinion. Such matters are the most difficult ones to distinguish. One of the outstanding examples of the items falling into this group is the provision for renewals and retirements taken out of income by public-utility companies in lieu of provision for depreciation. The entire subject of rate-making is involved in this question and in a large group of public-utility operating companies it is exceedingly doubtful that any two reputable engineers would agree on the exact amount to be provided at a given date to bring the properties down to their going-concern value. It is not a question of attempting to estimate the life of these properties or the salvage value and the resultant simple mathematical calculation of the amount which would be deducted per annum. The supreme court recently has indicated in the case of *The Illinois Bell Telephone Co.* that public-utility properties for all intents and purposes may be considered to be permanent and that for rate-making purposes they should not be written off to their salvage values during a period of years by what is more generally called a straight-line depreciation method. When the accountant is called upon to certify the accounts of public-utility companies, either as a unit or as a group, such as would be found in the larger public-utility holding companies, he is apt to find that he is faced with a question of technical skill and judgment which is not within his province. His only alternative in such cases is to state his position clearly and to refuse to accept responsibility for the amounts provided for renewals and retirements. In such circumstances naturally the company's officers would want to disclose the basis that they had used in making the provisions for renewals and retirements and should express definitely their opinion that they believe these provisions are fair and reasonable. Obviously the accountant can not attempt to relieve himself of responsibility if he has grounds for belief that the provisions made by the company are not reasonable.

Another instance, and one unfortunately which has been fostered by a suggestion in the federal reserve bulletin, is the question of examining deeds to property. In certain isolated cases such an examination might be practicable, but even if made, the fact that a deed existed which looked like a good deed would not necessarily mean that it constituted a title to the property. Accountants in their reports should state definitely that they are not responsible to the extent of seeing that the company has good title to its properties. It seems as though very little responsibility attaches to attorneys under either the securities act or the exchange act; certainly this is one that should properly belong to them.

Another example is the valuation of certain assets based on reports of other experts, such as appraisers and engineers.

A further example would be valuations given by the board of directors to properties acquired through issue of stock, etc. Practically all of the state laws place a definite responsibility on directors to value assets. Unless the accountant sees some very definite indication that these values are not reasonable, he should clearly state the source and basis of valuation and disclaim any further responsibility.

It would not be practicable in a discussion of this kind to attempt to enumerate further such questions or principles. However, it is not possible to stress too much the importance of the judgment that the accountant must exercise in reporting matters which fall into this category.

There is also a third distinct group of comments. Into this group would fall the larger number of qualifications that have regularly appeared in accountants' certificates for some years. They are usually definite questions of principle and occur in a statement of the accounts where all pertinent factors known to the accountant lead him to form an opinion different from that held by the management.

It seems to me that it must be remembered that the management of a company is the one primarily responsible for the statement of its accounts. The newly developed accountants' certificate suggested by a committee of the American Institute of Accountants, and accepted by the New York Stock Exchange and by the Controllers Institute begins by reciting that the accountant has made an examination of the balance-sheet and the other financial statements. Even in small companies where the accountant will necessarily render a more direct assistance in the preparation of the accounts from the standpoint of the law and certainly from the standpoint of accounting convention the accounts are representations made by the management.

Presumably it will always happen that differences of opinion between the management and the accountants will develop. As a practical matter, of course, the very heavy liabilities imposed on all parties by the securities and exchange acts will tend to a very large extent to prevent issuance of statement of account where there are decided differences of opinion as to the correct statement of certain items. It can not be expected, however, that the accountant's opinion will always be concurred in by the management or vice versa, and such things as the correct statement of accounts receivable before and after reserves, inventories, investments, fixed assets, abandonments of property, general reserves and the inclusion of controversial items in the income account or surplus accounts always will give rise to differences of opinion. In such instances the accountant is definitely committed by the acts to state that he has formed an opinion as to valuations, etc., different from the management.

During the past few weeks a committee of accountants composed in part of some of the members of the American Institute of Accountants, at the request of the securities and exchange commission, has been discussing suggestions for changes in the regulations under the securities act, as amended, and suggestions for regulations to be promulgated under the new securities exchange act. After these discussions had been fairly well completed and a more or less general agreement reached, a smaller sub-committee was appointed to discuss the suggestions with members of the securities and exchange commission. I think I can say without hesitation that every one on this committee has been most favorably impressed with the desires expressed by the members of the securities commission to make every attempt to simplify to the full extent allowed by the laws, all regulations to be issued under these acts. These commissioners have a very difficult administrative task to perform, and they have approached it most sympathetically.

The committee of accountants rendered a preliminary report to the securities and exchange commission in which the following recommendations were made in summary form:

1. The financial information required should be limited to that which will be of substantial value to investors.
2. Uniformity of major accounting principles in a particular industry is desirable as an ultimate objective, though uniformity in their application may be undesirable. For the present, corporations should be required merely to indicate the principles which are followed.
3. No standardized forms of financial statements should be prescribed. Statements in the form and detail best adapted to the particular conditions should be accepted.
4. There should be coördination of the requirements relative to financial statements for:
   (a) Listing on a national securities exchange;
   (b) Registration statements and prospectuses under the securities act of 1933;
   (c) Annual reports.
   This would entail substantial modification of the present regulations under the securities act.
5. The commission should endeavor to advise investors as to limitations of financial statements as guides to the value of investments.
6. If the commission should decide to require quarterly reports, these reports should consist only of income statements; they should be issued promptly; they should be in condensed and comparative form; and they may be based on estimates if necessary.
7. The commission should encourage corporations to adopt their natural business years as fiscal years.

To my mind the most important recommendation is the fifth, stressing the question of education of investors as to the limitations of financial statements as guides to the value of investments.

Profit-and-loss statements and balance-sheets must necessarily be based to a very large extent on a combination of judgment and estimates, and their real value to an intelligent investor lies in the guidance they may afford him as to the probable future results of operations.

Certain periodic expenditures such as rents, interest and wages can be determined with a fair degree of accuracy, but these are not the only elements which enter into the determination of the profits of a business enterprise. In the case of a going concern, for instance, how much can be realized from the ultimate collection of the accounts receivable? How much will the inventories of raw materials, goods in process and finished goods realize when sold? What can the investments be considered to be worth at a given time? How much depreciation or depletion or amortization has been accrued on physical plant, franchises and other fixed properties? All such questions call for technical skill and the application of judgment. Furthermore, it must be realized that the estimates made, in the light of circumstances then known, may be revised from time to time as new factors are discovered.

Without doubt, a review of all profit-and-loss statements, issued by large companies in past years, with the intent of discovering the misstatements which had been made on the basis of honest estimates, which later proved to be incorrect, would show startling results. Notwithstanding this, however, it would not be logical to take the position that the significance of statements of operations depends entirely upon their ultimate accuracy.

These and other basic factors underlying the preparation of all financial statements as of a given date, although thoroughly understood by accountants and by many business men as well, are not clearly appreciated by investors generally. This lack of clear understanding of the significance, the value and the limitations of financial statements on the part of the investing public has, of course, been the outstanding reason for the great storm of protest which arose on the passage of the securities act of 1933 at the inclusion of such heavy liability provisions.

The committee of accountants, at the request of the securities and exchange commission, submitted in draft certain specific suggestions for revised instructions to be issued for the registration of securities under the securities act and for the registration of securities on a national security exchange as provided by the securities exchange act. In making these suggestions the correspondence between the Institute's committee and the New York Stock Exchange, already referred to, was drawn on to a very large extent.

The outstanding features of these suggestions were, first, that so far as possible the commission in its regulations should avoid insisting on inflexible forms of financial statements; second, that the most important thing to accompany financial statements of registering corporations should be a statement of the accounting practices followed by the registrant.

Further, that in such a statement of accounting practices the question of consistency was of the utmost importance, and that a registering corporation should be required to indicate the effect of any material change in its practices from year to year.

It was also urged that wherever possible all historical information in the form of schedules for fixed assets, investments, capital stock, etc., should be eliminated, if not specifically required by the act itself.

No one can foretell what may be considered necessary for an accountant to sustain the burden of proof in court under the liability provisions of either the securities act of 1933 or the securities exchange act of 1934.

Perhaps too much emphasis has been laid on the unlimited liabilities of the acts, although unquestionably the hazards of continuing in professional practice have been greatly increased. However, if it has been possible for the accountant signing a registration statement to satisfy himself that he has been dealing with a client who is both ethical and responsible; if his examination has been complete and extensive so that it can be favorably compared with such other standards as have been raised voluntarily by the profession, for example, the federal reserve bulletin *Verification of Financial Statements;* if he has satisfied himself that his report and the statements covered by it outline, first, the accounting practices followed in the preparation of the accounts; second, such limitations of the scope of his examination as were considered necessary; and, third, the effect of any differences of opinion between himself and the management of the company as to the valuation or correct presentation of the accounts—then it seems to me that he is in a position to accept his responsibilities with the courage that comes from the confidence engendered by a piece of work well done.

FROM THE VIEWPOINT OF THE ATTORNEY

BY A. I. HENDERSON

Discussion of the securities act has tended to concentrate on the severity of the liability provisions and the technical difficulties of compliance with regulations of the commission with respect to financial statements. This is natural, since the problems they presented were immediate and pressing. Much less consideration has been given to the effect which the securities act, and to an even greater extent the securities exchange act, may have on general principles and methods of accounting, particularly on the conception of the general purpose and nature of financial statements. If my views are correct this legislation will ultimately bring about important changes in accounting practices and methods. I believe that the practical problems which arise under the acts should be considered from this broader point of view if accounting is to develop along sound lines, and I shall try to discuss some of those problems on that basis. You will realize, however, that this involves considerable conjecture and that my views must be taken as suggestions, not as final legal conclusions.

Practice under the two acts will, I believe, become substantially uniform—both because I think the commission will adopt regulations with that object in view and because it will be impossible in practice to maintain two different standards of accounting. I shall not, therefore, attempt to distinguish between the two acts.

I am not sure that it is generally recognized, but I think the exchange act is much the more important in its effect on accounting. It imposes liability for false or misleading statements in the financial statements of every corporation with a listed security. The commission will probably require that quarterly statements be filed in most cases. Furthermore, the principles established in the exchange act and the standards developed for financial statements subject to that act may well have a substantial effect on the development of the common law with relation to financial statements which do not fall under the act.

The most important change in the law made by these acts is the extent to which the field of responsibility of the accountant has been broadened. In the past every accountant relied to a greater or less extent on the theory that he was only responsible to the corporation that employed him to audit its books and that there was no practical responsibilty to the public, although this theory was qualified by judicial decision, notably by Judge Cardozo's opinion in the *Ultramares* case. The securities act and the exchange act, so far as statements filed under those acts are concerned, have entirely superseded this theory. In effect, the accountant, if he fails to exercise due care, is responsible to every investor, and the accountant must sustain the burden of proof that he exercised due care.

At first glance, the increase in the number of persons to whom the accountant may be liable seems to be the most important feature of this change in the law, since it greatly increases the danger of bedevilment by suits. Actually, I think the more important feature, in its effect on accounting methods, is the nature of the persons to whom accountants have been made responsible.

The officers of a corporation whose books the accountant audits have full knowledge of the affairs of the corporation; they are familiar with accounting practices and conventions. It is most unlikely that financial statements which have been prepared with even moderate care should mislead them. On the other hand, the investing public is not skilled in accounting, nor are most judges and juries. Accounting is a closed book to them. The investor generally regards a balance-sheet as a statement of fact rather than a statement of opinion. He does not recognize the limitations of figures as a means of showing financial condition. The misleading nature of financial statements will therefore, I believe, be determined not on what such statements convey to persons of substantially equal skill and knowledge, but on what they convey to persons who are not familiar with accounting practices and conventions. While an accountant may obtain a great deal of protection through footnotes to the financial statements and qualifications in his certificate, a balance-sheet and income statement which are plastered with footnotes and accompanied by several pages of qualifications are not very satisfactory in either practice or theory.

The acts clearly indicate that the purpose of publishing financial statements is to give information to the investor, not merely to check the bookkeeping of the corporation. I think the best protection for the accountant is to recognize this purpose and to approach the preparation of financial statements with it constantly in mind. When an accountant considers the form in which an item should be presented, he should try to place himself in the position of a layman and use the form of presentation which would be most effective in giving that layman a fair picture of the facts. He should not cling to accounting conventions which have no necessary justification; they will be a constant source of trouble. A balance-sheet is not and can not be a statement of fact; it must always be largely a matter of opinion. But I believe it is desirable to make it an opinion based as little as possible on artificial conceptions.

Nearly every balance-sheet carries certain items as assets which in no sense constitute real assets. It may be necessary to carry these items as assets, but in many instances I think the method followed is traditional. I am not convinced that a change in practice might not result in fairer balance-sheets and more accurate income statements. Recently I heard an accountant criticize the practice of certain corporations of charging bond discount against income for the year in which the bonds were sold, instead of setting it up as an asset and amortizing it over the life of the bonds. His reasons, of course, were that the practice made the income statement for future years inaccurate. I am not sure that he was right. He ignored the fact that from another point of view his method also made the income statement for future years inaccurate. He ignored the fact that he was setting up an entirely conventional asset on the balance-sheet; that the same information could be given to the investor by a statement of the practice of the corporation, and that such a statement would be more intelligible to most investors. He also ignored problems which arise with such an asset, if the bonds are retired before maturity.

I am not urging that immediate abandonment of established accounting conventions, even if they are unnecessary. Any such action would result in confusion and damage. At best, changes of this kind can only be made gradually over a considerable period of time. I believe, however, that development in accounting practice along this line will result not only in protection for the accountant, but also in increasing the value of financial statements to investors and others who are entitled to rely on them for information.

Another important point in the exchange act, in which it differs from the securities act, is the fact that a person who sells a security in reliance on a false or misleading statement as well as a person who buys a security in reliance on such a statement has a right of action. As a result of this provision liability can arise from understatement as well as from overstatement. By understatement I mean an understatement of favorable factors or an overstatement of unfavorable factors. It is true that liability for understatement exists at common law, but for various reasons it is not of much practical importance. Its importance under the exchange act should not be overemphasized. It is impossible to suppose that conservatism will be penalized to the same extent as exaggeration. Nevertheless, I think it requires some change in point of view on the part of accountants and others who prepare financial statements, and there are many situations where it may be of real importance.

There is another theory of accountants that I am afraid will not stand up under the acts. Many, if not all, accountants maintain that they do not prepare the financial statements but merely certify that the statements prepared by the corporation fairly represent the financial condition of the corporation as shown by its books. This theory may be sound; although, if you analyze your actual practice, I think you will realize that it is hard to reconcile the theory with the facts. I certainly do not think that accountants can rely on it for any great measure of protection, although it may give some protection in certain cases. I do not think anyone believes that a court will relieve an accountant of liability where there is a false figure on the books, which also appears in the balance-sheet or income account, unless the accountant can show that he was not negligent in failing to discover the error. The difference between that obvious case and a misleading presentation of particular items seems to me to be only a matter of degree, not of substance, and I do not expect the courts to make any such distinction. Whether or not the accountant actually "prepares" the financial statements is, I am afraid, largely immaterial. He is expressly made liable under the securities act and although he is not named in the exchange act, I think it must be assumed that an accountant is a person who makes, or causes to be made, statements in financial statements filed under the act, and therefore, liable under Section 18, unless the courts decide otherwise.

The book value of fixed assets is in most cases an artificial figure. It does not represent realizable value or replacement value. It is usually nothing but a bookkeeping figure which may be based on cost, independent appraisals, the judgment of the directors and a number of different factors. There is little doubt, however, that the average investor regards this figure as representing a number of dollars which can be realized in one way or another. It is true that skilled investors know that this view is not correct, and they recognize that it does not purport to be a realizable value, and that it is the general practice to treat it as an artificial figure. Nevertheless, I do not believe that it is safe to rely on this general practice. One reason for my belief is that, while the practice is to treat the figure as a book figure, there is and can be no uniformity in the method used in arriving at the book figure. The accountant should, therefore, indicate clearly the fact that the figure is a book figure and also indicate what it does not show. I am not suggesting that the amount shown on the balance-sheet should be changed or that the accountant attempt to estimate a realizable value or that he insist on obtaining an appraisal. That would be obviously impracticable and would disrupt corporate accounting. But I believe that the nature of the figure should be clarified, that, as far as practicable, the bases on which it is determined should be shown, and possible misconceptions of its nature should be negatived. This can best be done by a footnote to the balance-sheet.

There may also be problems arising from liability for understatement in this account—always keeping in mind, however, that the danger of liability from understatement should not be exaggerated. When the book figure is clearly less than the actual value of the property, I do not think that fact can be ignored. Suppose, for example, that a corporation has acquired land for $100,000, which is carried on the balance-sheet at cost, and a vein of gold has been found on the land so that its value is greatly increased, and the accountant has knowledge of this. I do not believe that it is safe to carry the land at cost on the balance-sheet and to leave this fact unnoted, even though there has been no write-up on the books of the corporation and none is contemplated. I do not mean by this that the accountant should attempt to estimate the increased value of the land, but there should be a note on the balance-sheet indicating that the cost figure does not represent the present value and that the present value may be in excess of the balance-sheet figure. If there has been an appraisal or other determination of the value, the footnote should probably disclose that figure. A similar problem is presented when property which has been fully depreciated, but still has a substantial value, is not carried on the balance-sheet.

Investment securities present analogous problems. If the securities are carried at cost and the value has greatly increased, the problem is the same as in the example I have given of land. If the securities are carried at market value that may be misleading if the block is so large that it can only be disposed of at substantially less than current quotations or if the block represents control and is, therefore, worth substantially more than current quotations. The value at which stock of a subsidiary is carried may also require consideration. If the value is substantially less or more than its liquidating value, as shown by the books of the subsidiary, that should be indicated. In some cases, however, that may not be enough. A statement that the value on the balance-sheet of the parent company is the book value shown on the books of the subsidiary is not very informative and may be insufficient, even though the balance-sheet is accompanied by a balance-sheet of the subsidiary. It may be necessary to incorporate the substance of any notes on the balance-sheet of the subsidiary in a note on the balance-sheet of the parent company.

Items such as patents and goodwill, which are ordinarily, and I think properly, carried at a purely nominal value, present similar questions. If the value at which patents are carried on the balance-sheet is a nominal one only and if, in fact, the patents so carried bring large royalties to the corporation, or are responsible for substantial income to the corporation, a note to this effect should be made. However, I do not think the accountant should attempt to put a dollar value on the patents.

Goodwill may, perhaps, be treated somewhat differently. I think there is a question whether any such item as goodwill has ever belonged on a balance-sheet, but, since it is recognized that it may be so carried, is it safe to omit goodwill entirely, or carry it at $1.00, if it is clearly an important factor in the business of the corporation? I am not sure of the answer, but I incline to the view that no explanation is necessary. Certainly, if goodwill is carried at a substantial value, it will ordinarily require an explanatory note.

Reserves, including the reserve for depreciation, are other items which will frequently require annotation. The basis on which such reserves are set up should, I think, be given. If the reserves vary from those usually considered necessary or if the accountant believes that the reserves are substantially inadequate or excessive, those facts should be indicated.

The treatment of surplus is a difficult question. Most of the difficulty arises, I think, from the classification of surplus, which is, I believe, an unfortunate practice. The corporation laws which permitted stock without face value are partly responsible for the practice, but the accountants themselves must also share the responsibility.

In my opinion surplus or deficit is only a balancing item on the balance-sheet. It is the arithmetical difference between assets and liabilities, including capital stock. It is important for the investor to know how that difference was created, but I do not think that this can be done accurately on the balance-sheet. I should, therefore, like to see only one item of surplus on the balance-sheet and to have the balance-sheet accompanied by an analysis of surplus, which should show the surplus at the beginning of the period under review and all credits and charges to surplus during the period.

Unfortunately, classification of surplus is such a well established practice that there is little chance that it will be abandoned. I do think, however, that any classification may convey to the mind of the investor certain implied representations which are frequently incorrect and that, therefore, it will often be necessary to annotate surplus so as to deny those implied representations. For example, I am afraid that an item "earned surplus" implies to many investors that the amount is available for dividends and that it is the only amount available for dividends. The availability of surplus for dividends is primarily a legal question and an extremely difficult one. It is often the case that the accountant's figure for earned surplus on the balance-sheet does not conform to the amount available for dividends, in the opinion of counsel for the corporation.

It is also fairly common to see a statement on a balance-sheet that part of the surplus is not available for dividends. The authority for any such statement should, I think, always be stated, such as an opinion of counsel or specific provisions in the charter of the corporation. It is not, however, a statement which I think an accountant can or should make as his own and I think that he may incur liability for so doing if his conclusion happens to be incorrect.

In considering the income statement, I believe that the accountant should realize that it is being recognized more and more as the important statement for the investor—more important than the balance-sheet. As this importance is recognized, the necessity for accuracy becomes correspondingly important. As a practical matter I believe that errors in the income statement are much more apt to be the basis for liability than errors in the balance-sheet. Since a common method of estimating the fair market value is to multiply the earnings per share by 10 or some other arbitrary figure, an error in the income statement is in practice considerably magnified.

Particular care should be taken with non-recurring items. I doubt if general statements will usually be enough. Frequently it will be advisable to specify the nature of the non-recurring items, and when the amounts of such items are available, I believe they should be given.

The effect of depreciation and other reserves on the income statement is so well recognized that it needs little discussion. I feel, however, that too much emphasis has been put on the rates at which depreciation is taken and not nearly enough emphasis has been placed on consistency in those rates, and—what is perhaps even more important—on the valuation of the assets on which the depreciation is based. In many cases where a footnote has been made on the balance-sheet relating to the value at which assets are carried or to depreciation or other reserves, it will frequently be necessary to make a corresponding note on the income statement.

I referred before to the protection which the accountant can obtain by the form of his certificate. There is no doubt that he can protect himself in many respects by his certificate, but I do not think that it is in any sense complete protection. It is important that the certificate correctly state the scope of the examination and that it be accurately phrased. It can, I think, qualify the financial statements by excluding certain questions which have not been covered because they are outside the field of accounting. It will often be advisable to include a statement of the principles and methods which have been followed, such as the method of taking inventory or of checking accounts receivable. I do not believe, however, it is desirable to use the certificate as a substitute for footnotes on the balance-sheet. If any item in the balance-sheet requires qualifying or explanatory comment, I believe it is much better practice to carry those comments, wherever practicable, as footnotes to the balance-sheet, although they may also be included in the certificate. In other words, I do not think that a certificate should be used to correct an incorrect balance-sheet. Furthermore, I do not think that when a matter is really within the field of accounting a statement in the certificate that the accountant does not take any responsibility for it will necessarily be an effective defense against liability. For example, I think it is probably effective to state in the certificate that one is not responsible for the validity of legal title to the properties of the corporation. I think it is doubtful if a statement that the accountant did not check the accounts receivable will relieve him of liability, in the absence of valid reasons for not making such a check. I recommend that so far as possible notes in qualification and explanation of balance-sheet items should appear on the balance-sheet as notes to the particular items affected and not as qualifications in the certificate or at least that items which are qualified in the certificate should carry a specific reference to the certificate. A properly annotated balance-sheet, with a short and simple certificate which accurately describes the scope of examination, is, I think, more desirable and probably more effective than a treatise on the things which have not been done. I recognize that this may lead to cumbersome notes and strange looking balance-sheets. Perhaps the answer is that if the notes make the balance-sheet look ridiculous, it is time to consider whether or not the items in the balance-sheet do not need revision. Probably a good many balance-sheets would be substantially improved by revision. I hope to see the number of notes required constantly decrease as accounting develops and improves.

The accountant can also obtain some protection from certificates furnished by officers of the corporation to the effect that all facts within their knowledge have been disclosed. Such certificates are valuable, but they must not be relied on to take the place of the work which the accountant should do himself. The purpose of such certificates is to enable the accountant to check the facts which he has discovered through his examination, not to take the place of the examination.

Another very important matter for the accountant's own protection is the manner in which he keeps his working papers and records. It is important not only for the accountant but also for the officers and directors of corporations whose accounts he audits that he should keep complete records of the work which he does and that these records should be prepared at the time the work is done and should be signed by the man who does it. Such records will be the chief evidence which he will have in any suits which may be brought against him in reference to financial statements. Working papers and records may do more harm than good, however, if they are not entirely accurate. It is very easy for rough working papers to contain statements which are not entirely accurate and will be corrected in the final report. Nevertheless, the existence of such a paper, which contradicts the final report, may be a difficult thing to explain in a court several years later in the face of a hostile examination. Even more important is the danger of including inferences, opinions or recommendations in working papers, which, for one reason or another, are not followed in the report. For example, a junior accountant, in going over the books, may make a note that a certain entry is in his opinion incorrect. His seniors, however, may not agree with this conclusion and may overrule him. In such cases I think it is essential that the records should show that the conclusion of the junior accountant was overruled, not overlooked, and the reasons for which it was overruled. The best way to avoid those difficulties, however, is to insist rigidly that working papers be entirely accurate, be confined so far as possible to facts and shall not include premature conclusions or criticisms.

I have so far discussed only those things which the accountant should do in order to protect himself. In the effort to protect himself, the accountant must remember that he owes a duty to the corporation which employs him. There are certain risks involved in doing business as an accountant and those risks must be recognized and accepted. It is perfectly possible that by leaning too far backward an accountant may place corporations and their officers and directors in an extremely difficult position which is not justified by the facts. It is a fairly common practice for accountants to write reports or memoranda recommending changes in the methods of accounting followed by a corporation. I do not mean to discourage accountants making such recommendations in unqualified terms where they believe that they are essential to a sound and honest presentation of the financial condition of the corporation. I do wish to point out, however, that the form of such recommendations, if they are matters of opinion, is important. Such memoranda should clearly indicate that they are matters of form or judgment and not of substance, so that if the officers and directors do not elect to adopt the recommendations it will not appear that they have followed improper methods against the advice of the accountant when, in fact, this was not the case. From the accountant's own point of view such memoranda also may be extremely dangerous. I can think of no surer way by which an accountant may make himself liable than to have produced in court a memorandum submitted by him to a corporation criticizing the methods of accounting of the corporation in a matter of substance, followed a few months later by published financial statements which he certified and in which his recommendations are not adopted.

I may have given the impression that I am very critical of the two acts. While I believe experience will prove that the acts require amendment in many respects, and that there is far too much emphasis on detailed information, I believe that the purpose of the acts is sound and that many of their provisions will prove to be of real benefit. While the securities act sometimes appears impossible to work under, I think that the securities commission is sincerely trying to facilitate operations under that act and that in a large measure the commission will be successful in that effort. I expect that regulations under the exchange act will be adopted which will prove workable.

I believe that this legislation will give accountants a real opportunity to develop the practice of accounting on sound and constructive lines. Let me repeat that accounting practice should develop on a basis which recognizes that the purpose of financial statements is to disclose the financial condition of a corporation and that such statements are not academic exercises in intricate accounting methods. Failure to recognize this will result not only in missing the opportunity for constructive improvement of accounting practice but will also greatly increase the dangers of liability for accountants. To put it another way, I believe accountants should deal with the problems which may arise on a common-sense basis, that the solution of doubtful questions should be guided by an endeavor to render financial statements as intelligible as possible to unskilled investors, and that accounting practices and conventions which are confusing to the investor should be discouraged.

The Illinois Bell Telephone Company Case

By Percival F. Brundage

The recent decision of the supreme court of the United States in the Illinois Bell Telephone Company case is so important in respect to much debated depreciation questions for rate purposes that a resumé should be of interest to all accountants.

Justice Butler in a concurring opinion took the definite position that straight-line depreciation is not acceptable for rate purposes. He said: "Amounts sufficient to create a reserve balance that is the same percentage of total cost of depreciable items as their age is of their total service life can not be accepted as legitimate additions to operating expenses."

The opinion of the court delivered by Chief Justice Hughes did not go so far as this but decided the issue rather upon the particular facts disclosed. After explaining that the company had used the straight-line method of computing depreciation, "a method approved by the interstate commerce commission," the court held that, "the point is as to the necessity for the annual charges for depreciation, as made or claimed by the company, in order to avoid confiscation through the rates in suit. . . . The questionable amounts annually charged to operating expenses for depreciation are large enough to destroy any basis for holding that it has been convincingly shown that the reduction in income through the rates in suit would produce confiscation."

In previous decisions, the supreme court has held that the rate base on which a fair return is to be computed is "the present value" and not the original cost of the property used in the service rendered. In the United Railways & Electric Co. case (280 U. S. Pur 1930 A), the supreme court sustained the court of appeals of Maryland in holding that the allowance for annual depreciation should also be based upon "present value." In the Illinois Bell Telephone Company case the court holds that the computation of the annual depreciation provision is not independent of the rate base. Furthermore, after this decision, it is difficult to see how straight-line depreciation can ever be sustained as a charge to operating expenses in determining whether a rate is compensatory or confiscatory. The decision, it is true, was based upon the facts of the particular case, but a similar relation between the amount of accumulated reserves and the observed depreciation for any company that has been in business for a substantial number of years would of necessity seem to exist in all cases in which the straight-line method has been employed. This is of particular interest in New York state where the public service commission has recently prescribed straight-line depreciation as an accounting requirement for all utilities in the state.

The facts of the Illinois Bell Telephone Company case were briefly as follows. The Illinois commerce commission on August 16, 1923, reduced rates applicable to part of the intrastate business of the Illinois Bell Telephone Company effective October 1, 1923. In September, 1923, the telephone company obtained an interlocutory injunction restraining the commission from enforcing the rate reduction on the condition that, if the injunction were dissolved, the company would refund the amounts charged in excess of the challenged rates. It was the second time that this case had been before the supreme court, and that court in its decision of April 30, 1934, reversed the decree of the district court, dissolved the injunction and required the company to refund the amounts charged in excess of the rates in this suit during the whole period up to that date, amounting to approximately a million and a half dollars a year.

The company in presenting its case had endeavored to sustain two contentions, which the court held to be contradictory, (1) that the depreciation charge against earnings on a straight-line basis was no more than was required in order to provide for the accruing loss of useful value during the period, and (2) that the property had been maintained in the best possible condition, was modern in every respect and that "the existing depreciation in the property, physical and functional, did not exceed 9 per cent. in the years 1923 to 1928 and 8 per cent. thereafter," while the depreciation reserve accumulated on the straight-line basis had reached an amount in excess of 25 per cent. of the cost of the property. Chief Justice Hughes in dismissing the injunction said: "The company has had abundant opportunity to establish its contentions. In seeking to do so, the company has submitted elaborate estimates and computations, but these have overshot the mark. Proving too much, they fail of the intended effect."

The court defines depreciation as follows:

"Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy, and obsolescence. Annual depreciation is the loss which takes place in a year. In determining reasonable rates for supplying public service, it is proper to include in the operating expenses, that is, in the cost of producing service, an allowance for consumption of capital in order to maintain the integrity of the investment in the service rendered. The amount necessary to be provided annually for this purpose is the subject of estimate and computation. In this instance, the company has used the 'straight line' method of computation, a method approved by the interstate commerce commission."

The following discussion of the depreciation charge and comparison of the accumulated balance of the reserve with the observed depreciation of the engineer's estimate is very concise and constitutes the clearest statement on this point that has appeared in any court decision.

"Confiscation being the issue, the company had the burden of making a convincing showing that the amounts it has charged to operating expenses for depreciation have not been excessive. That burden is not sustained by proof that its general accounting system has been correct. The calculations are mathematical but the predictions underlying them are essentially matters of opinion. They proceed from studies of the 'behavior of large groups' of items. These studies are beset with a host of perplexing problems. Their determination involves the examination of many variable elements and opportunities for excessive allowances, even under a correct system of accounting, are always present. The necessity of checking the results is not questioned. The predictions must meet the controlling test of experience.

"In this instance, the evidence of expert computations of the amounts required for annual allowances does not stand alone. In striking contrast is the proof of the actual condition of the plant as maintained—proof which the company strongly emphasizes is complete and indisputable in its sharp criticism of the amount of accrued depreciation found by the district court in valuing the property. The company insists that 'the existing depreciation in the property, physical and functional, does not exceed 9 per cent. in the years 1923 to 1928 and 8 per cent. thereafter.' The existing depreciation as thus asserted by the company, and the amounts it shows as the depreciation reserve allocated to the intrastate business in Chicago (taking in each case the average amounts per year) are as follows:

"Years	Existing depreciation	Depreciation reserved
1923	$11,992,000	$26,797,000
1924	12,865,000	29,316,000
1925	13,775,000	32,155,000

1926	$14,621,000	$35,572,000
1927	15,360,000	39,352,000
1928	16,241,000	42,769,000
1929	15,300,000	44,515,000
1930	15,863,000	45,829,000
1931	15,828,000	48,362,000"

Too little attention has been given by many utilities heretofore to the interrelation of the rate base and the depreciation charge. Telephone companies generally have been willing to compute the annual depreciation charge on a straight-line basis as approved by the interstate commerce commission, relying on several supreme court decisions that the rate of return must be calculated on present value of the plant and not on original cost less computed depreciation. The case of the company as summarized by the supreme court appears to bring out the conflict of bases in a very direct way, and that court has now definitely indicated that a company can not eat its cake if it wishes to have it for a consumer's party.

On the one hand is the argument that the depreciation charge is correct and computed in accordance with the requirements of the interstate commerce commission. On the other hand is the statement that the plant "was not functionally deficient, in any practical sense." Although the balance of the depreciation reserve increased between two and three million dollars a year during this period, the company's counsel stated that:

"The percentage of depreciation in the various classes of plant did not vary materially during the period, with the exception of three classes, namely, central office equipment, private branch exchanges and booths and special fittings. In the case of central office equipment, there were large installations of new equipment in 1929 which had the effect of raising the per cent. condition for the entire class from 92 per cent. for prior years to 93 per cent. for 1929 and subsequent years. In the case of private branch exchanges, the percentage condition improved gradually from 88 per cent. in 1923 to 94 per cent. in 1930 due to the large proportion of new installations and correspondingly large retirements of the old. In the case of booths and special fittings, the percentage condition gradually improved from 78 per cent. in 1923 to 85 per cent. at the end of the period, in this case also because of abnormally large changes of booths at pay stations. These are the changes which in the main account for the fact that the overall condition of the plant rose from 91 per cent. for the years 1923–1928 to 92 per cent. thereafter."

In view of the definiteness of the above statements, it is not perhaps surprising that the court held that the burden of proof that the depreciation charges included in operating expenses were fair and reasonable had not been sustained.

"In the light of the evidence as to the expenditures for current maintenance and the proved condition of the property—in the face of the disparity between the actual extent of depreciation, as ascertained according to the comprehensive standards used by the company's witnesses and the amount of the depreciation reserve—it cannot be said that the company has established that the reserve merely represents the consumption of capital in the service rendered. Rather it appears that the depreciation reserve to a large extent represents provision for capital additions, over and above the amount required to cover capital consumption. This excess in the balance of the reserve account has been built up by excessive annual allowances for depreciation charged to operating expenses."

The court's reference to maintenance as related to the depreciation charge is also interesting:

"In the process of current maintenance, 'new parts' are 'installed to replace old parts' in units of property not retired. Such 'substitutions or repairs' are separate from the amounts which figure in the depreciation reserve. The distinction between expenses for current maintenance and depreciation is theoretically clear. Depreciation is defined as the expense occasioned by the using up of physical property employed as fixed capital; current maintenance, as the expense occasioned in keeping the physical property in the condition required for continued use during its service life. But it is evident that the distinction is a difficult one to observe in practice with scientific precision, and that outlays for maintenance charged to current expenses may involve many substitutions of new for old parts which tend to keep down the accrued depreciation."

As already pointed out, Justice Butler goes even further than the court in taking a definite position against straight-line depreciation. He gives a number of tables and statistics in support of the court's decision and then concludes as follows:

"From the foregoing it justly may be inferred that charges made according to the principle followed by the company create reserves much in excess of what is needed for maintenance. The balances carried by the company include large amounts that never can be used for the purposes for which the reserve was created. In the long run the amounts thus unnecessarily taken from revenue will reach about one-half the total cost of all depreciable parts of the plant. The only legitimate purpose of the reserve is to equalize expenditures for maintenance so as to take from the revenue earned in each year its fair share of the burden. To the extent that the annual charges include amounts that will not be required for that purpose, the account misrepresents the cost of the service.

"The company's properties constitute a complex and highly developed instrumentality containing many classes of items that require renewal from time to time. But, taken as a whole, the plant must be deemed to be permanent. It never was intended to be new in all its parts. It would be impossible to make it so. Expenditures in an attempt to accomplish that would be wasteful. Amounts sufficient to create a reserve balance that is the same percentage of total cost of depreciable items as their age is of their total service life can not be accepted as legitimate additions to operating expenses. In the absence of proof definitely establishing what annual deductions from revenue were necessary for adequate maintenance of the property, the company is not entitled to have the rate order set aside as confiscatory."

If this had been the opinion of the court, the situation today would at least be clearer than it actually is. However, accountants must realize too well the necessity of deciding cases as they arise to have any just cause for complaint at the unwillingness of the court to go further than deciding the case immediately before it.

Students' Department

H. P. BAUMANN, *Editor*

GOODWILL IN CONSOLIDATED BALANCE-SHEET PPOBLEMS

If a company pays an amount in excess of the net assets acquired from another, such excess is generally stated on the books of the purchasing company as a payment for goodwill. If, however, the net assets are not acquired, but the payment is made for the entire capital stock of the selling company, any payment in excess of the net assets (book value) of the selling company is regarded, also, as a payment for goodwill. Such goodwill does not appear on the books of the purchasing company but arises when the accounts of both companies are consolidated.

The amount of goodwill, for consolidated balance-sheet purposes, can readily be ascertained by scheduling the accounts representing the book value of the subsidiary at the acquisition date, and subtracting this amount from the cost of the investment, as follows:

Purchase price		$175,000
Book value of subsidiary:		
Capital stock	$100,000	
Surplus	50,000	
Total book value		150,000
Goodwill purchased		$ 25,000

If the par value of the stock in the above case was $100 per share, the purchasing company's interest may be stated as follows:

	Total	Per share
Net assets	$150,000	$150
Goodwill	25,000	25
Purchase price	$175,000	$175

The point to be remembered here is, that the value of the goodwill per share attaching to any purchase is set once and for all at the time of the purchase. Testing this point, let us assume that 10 per cent. of the stock in the subsidiary was sold by the parent company for $20,000. The entry to record this sale would appear on the parent company's books as follows:

Cash		$ 20,000	
Investment in subsidiary			$ 17,500
Surplus			2,500
To record the sale of 100 shares of stock in the subsidiary company:			
Sales price	$20,000		
Cost	17,500		
Profit	$ 2,500		

The balance in the investment account would now show $157,500 and the parent company's interest would be but 90 per cent. If the accounts were now consolidated, we would have:

Investment account		$157,500
Book value of subsidiary:		
Capital stock	$100,000	
Surplus	50,000	
Total book value	$150,000	
90% thereof		135,000
Goodwill		$ 22,500

The total amount of goodwill still owned checks in the following statement with what was sold when the parent company disposed of 10 per cent. of its interest in the subsidiary.

	Amount originally purchased (100%)	Amount sold (10%)	Balance still owned (90%)
Net assets	$150,000	$15,000	$135,000
Goodwill	25,000	2,500	22,500
Investment account	$175,000	$17,500	$157,500

Let us try our hand with the following problem which involves two purchases and a sale of stock in a subsidiary.

On January 1, 1933, Company A purchased 80 per cent. (800 shares) of the capital stock of Company B for $120,000. On June 30, 1933, it purchased the remaining 20 per cent. (200 shares) for $30,000. This latter block (20 per cent.) was sold on December 31, 1933, for $40,000, and the profit of $10,000 was credited directly to surplus. Compute the goodwill arising through consolidation.

	Companies	
Assets	A	B
Assets	$300,000	$200,000
Investment in Company B:		
800 shares at cost	120,000	
	$420,000	$200,000
Liabilities and capital		
Liabilities	$ 30,000	$ 50,000
Capital stock	300,000	100,000
Surplus January 1, 1933	40,000	20,000
Profits to June 30, 1933	20,000	10,000
Profits from July 1 1933, to December 31, 1933	30,000	20,000
	$420,000	$200,000

The amount of the goodwill arising through the two purchases may be scheduled as follows:

	1st purchase (80%) Jan. 1, 1933	2nd purchase (20%) June 30, 1933
Book value of Company B; at dates of acquisition:		
Capital stock	$100,000	$100,000
Surplus, January 1, 1933	20,000	20,000
Earnings to June 30, 1933		10,000
Book value	$120,000	$130,000
80% thereof	$ 96,000	
20% thereof		$ 26,000
Purchase price	120,000	30,000
Goodwill purchased	$ 24,000	$ 4,000

However, the 20 per cent. purchased on June 30, 1933, was sold on December 31, 1933, so that Company A disposed of its 20 per cent. interest in the net assets and the $4,000 of goodwill which it paid for at the time of the purchase. The only goodwill appearing in the consolidated statement at December 31, 1933, would be the $24,000 arising from its first purchase which it still retains.

If the problem did not definitely state that it was the second purchase which was sold, it would be necessary to apply the rule of "first-in, first-out" to arrive at a correct solution. The holdings of the parent company at December 31, 1933, would be—60 per cent. of the entire capital remaining from the first purchase, and the 20 per cent second purchase. The goodwill arising at the time of the second purchase ($4,000) would remain the same; that acquired with the first purchase would be reduced by (20/80) the 20 per cent. sold therefrom. The following analysis of the first purchase shows that with the sale of the 20 per cent. interest there was included $6,000 of the purchased goodwill, and that the goodwill at December 31, 1933, would be:

Remaining from 1st purchase	$18,000
2nd purchase	4,000
Total	$22,000

		Original purchase (80%)	Sold therefrom (20%)	Balance remaining (60%)
Book value of Company B at January 1, 1933:				
Capital stock	$100,000	$ 80,000	$20,000	$60,000
Surplus	20,000	16,000	4,000	12,000
Totals	$120,000	$ 96,000	$24,000	$72,000
Purchase price		120,000	30,000	90,000
Goodwill		$ 24,000	$ 6,000	$18,000

Time, however, can be saved in an examination by recognizing that the 80 per cent. interest on hand at the balance-sheet date (December 31, 1933) is made up of 60 per cent. from the first purchase and the 20 per cent. second purchase. The computation can then be made as follows:

	1st purchase (60%) Jan. 1, 1933	2nd purchase (20%) June 30, 1933
Book value of Company B at dates of acquisition:		
Capital stock	$100,000	$100,000
Surplus, January 1, 1933	20,000	20,000
Earnings to June 30, 1933		10,000
Book value	$120,000	$130,000
60% thereof	$ 72,000	
20% thereof		$ 26,000
Purchase price	90,000	30,000
Goodwill purchased	$ 18,000	$ 4,000

In the above examples, the book values were represented by a capital stock and a surplus account. All problems are not so simple. The following has caused many students to scratch their heads in an unconscious effort to find the answer.

The A Company's balance-sheet at December 31, 1933, contained the following accounts:

Capital stock authorized	$200,000
Unissued stock	30,000
Treasury stock (50 shares, par $100) cost	7,500
Surplus	20,000
Capital surplus (arising from appraiser's revaluation of fixed assets)	4,500
Premium on stock (issued at 110)	17,000
Reserve for sinking fund	35,320
Reserve for extension of plant	20,000

On the same date the B Company bought 90 per cent of the outstanding stock at 170 and acquired the treasury stock and the unissued stock at 150. Compute, for consolidated balance-sheet purposes, the goodwill arising from the transactions.

First, it would be well to list those accounts which are a part of the net worth section in order to ascertain the book value of the net assets at the date of acquisition.

As the unissued stock and the treasury stock were acquired on the same date that B Company purchased the 90 per cent. of the then outstanding stock, all of the authorized capital stock of A Company is outstanding. Hence:

Book value of A Company, December 31, 1933:	
Capital stock	$200,000
Surplus	20,000
Capital surplus	4,500

Premium on stock:		
Original issue	$17,000	
Unissued stock sold to B Company	15,000	$ 32,000
Surplus reserves:		
For sinking fund	$35,320	
For extension of plant	20,000	55,320
Total book value (2,000 shares)		$311,820

The treasury stock which was carried at $150 per share was sold to the B Company at the same price, and has no bearing upon the net worth of A Company. The unissued stock, however, was sold at a premium of $50 per share and the net worth was increased by (300 shares at $50 premium) $15,000. This is more readily apparent if the transactions are recorded in "T" accounts.

The next step is to compute the holdings and the purchase price thereof:

Purchase of original outstanding stock:			
90% of 1,650 shares	1,485	Shares at $170	$252,450
Unissued stock	300	Shares at $150	45,000
Treasury stock	50	Shares at $150	7,500
Totals	1,835		$304,950

The computation of goodwill follows:

Purchase price	$304,950
Proportionate book value:	
(1,835/2,000 of $311,820)	286,095
Goodwill purchased	$ 18,855

Unless the student consistently hews to the line in determining the book values of the subsidiary companies, he is apt to find himself wool-gathering at the end of the allotted time for solving a problem in major-minor holding companies.

Given the following:

Balance-sheets, December 31, 1933

	A Company	B Company	C Company
Investment in B Company—4,000 shares at cost	$ 600,000		
Investment in C Company—800 shares at cost		$ 200,000	
Other assets	1,900,000	800,000	$300,000
	$2,500,000	$1,000,000	$300,000

Liabilities	$ 665,000	$ 300,000	$ 83,000
Capital stock—common:			
10,000 shares of $100 each	1,000,000		
5,000 shares of $100 each		500,000	
1,000 shares of $100 each			100,000
Surplus—January 1, 1932	700,000	150,000	100,000
Net operating income:			
Six months ended June 30, 1932	8,000	3,000	1,000
Six months ended December 31, 1932	12,000	5,000	3,000
Six months ended June 30, 1933	35,000	12,000	3,000
Six months ended December 31, 1933	80,000	30,000	10,000
	$2,500,000	$1,000,000	$300,000

The A Company acquired 3,750 shares of common stock of the B Company on January 1, 1933, and a further acquisition was made of 250 shares on June 30, 1933, the cost price in both cases being $150 a share. The B Company acquired 800 shares of the C Company—an 80 per cent. interest—on June 30, 1932, for $200,000. What is the amount of the goodwill arising in the consolidation of the accounts?

The amount of goodwill in the case of B's purchase of the 80 per cent. interest in C is easily computed, as follows:

Purchase price		$200,000
Proportionate interest in the book value of C Company at the date of acquisition—June 30, 1932:		
Capital stock	$100,000	
Surplus—January 1, 1932	100,000	
Income to June 30, 1932	1,000	
Total book value	$201,000	
80% thereof		160,800
Goodwill purchased		$ 39,200

However, in the case of A's acquisition of its interest in B, it is necessary to consider, as a part of B Company's net worth, its interest in the profits of C Company (B's subsidiary) earned during the period of B Company's holding. For example:

	Book value			
	Total	Proportionate interest	Purchase price	Goodwill
Acquisition by A Company of stock of B Company:				
Capital stock	$500,000			
Surplus—January 1, 1932	150,000			

Earnings, for six months ended:				
June 30, 1932	$3,000			
December 31, 1932	5,000			
Pro-rata share (80%) of profits of C Company accruing to B Company during the six months ended December 31, 1932:				
(80% of $3,000)	2,400			
Book value, December 31, 1932	$660,400			
75% thereof		$495,300	$562,500	$67,200
Earnings for six months ended June 30, 1933:				
B Company	12,000			
Pro-rata share of C Company:				
(80% of $3,000)	2,400			
Book value, June 30, 1933	$674,800			
5% thereof		33,740	37,500	3,760
Totals		$529,040	$600,000	$70,960

It will be noted:

1. That the 80% interest of B Company in the earnings of C Company during the period from July 1, 1932 (the date B Company acquired the 80% interest in C Company) to December 31, 1932, are included in the net worth of B Company as at the latter date (the date A Company acquired its 75% interest in B Company).
2. That the 80% interest of B Company in the earnings of C Company during the period from January 1, 1933, to June 30, 1933, are included in the net worth of B Company, because it was on this latter date that A Company purchased an addition interest of 5% in B Company.

In this discussion, the examples used treat of "positive" goodwill. Had the purchase price been less than the book value of the subsidiary at the date of acquisition, "negative" goodwill (whatever that is) or capital surplus would have arisen. The methods would have been the same.

I have received many inquiries relative to the so-called negative goodwill. While the term "capital surplus" is often used, I prefer "surplus arising through consolidation," primarily because the term "capital surplus" is generic. However, if the examiners require a statement of goodwill and capital surplus, the candidate should use the same terms in his solution.

Students should be on the alert to discover, whether what may ordinarily appear to be goodwill or surplus arising through consolidation is not, on the facts given in the problem, something else. Problem 2 of part I of the examination in accounting theory and practice set by the board of examiners of the American Institute of Accountants on May 11, 1933, is a good example. In this problem, the X Refining Corporation purchased the entire outstanding stock of the K. O. Producing Company, at a price of $695,000. The adjusted net worth of the Producing Company at the date of sale was $187,351. On the surface, it would appear that the difference, $507,649 was paid for goodwill. The following is quoted from the discussion of the problem and solution which appeared in the *Students' Department* of THE JOURNAL OF ACCOUNTANCY, page 138, issue of August, 1933.

"This 'goodwill' of $507,649, when contrasted with the K. O. Producing Company's net assets of only $187,351, indicates very clearly that the value of the company's oil reserves is far in excess of their book cost. From the standpoint of the consolidated group, this $507,649 may be considered as representing additional cost of the oil properties. Furthermore, the oil will be exhausted in less than three years at the 1930 rate of production. For these reasons it is necessary to write off this $507,649 property premium against the income from the oil property, on the basis of barrels of oil produced.

"If this is not done, the income of the consolidated group will be overstated for the next three years. Then, when all of the oil has been extracted, the premium of $507,649 will remain on the books, a worthless asset."

Some writers indicate that "negative" goodwill may be the result of an overstatement of an asset or assets of the subsidiary. Caution should be exercised by the student in following this suggestion. He must be absolutely certain that the data given him in the problem will sustain any such interpretation. I know of few problems in which the assets of the subsidiary could be reduced by the amount of the surplus arising through the consolidation. But one does not know what to expect these days.

Book Reviews

PROBLEMS IN ACCOUNTING, by HOSMER, SANDERS AND HANSON, *McGraw-Hill Book Company, Inc.* 463 pages. 1934.

The latest of the "Harvard Problem Books," *Problems in Accounting*, is intended for general use in the study of accountancy, not only by future accountants but also by students in other business courses. It uses the case system as a method of instruction and is primarily a college text-book. It is divided into five parts.

Part I gives an "introduction to accounts, balance-sheets and operating statements." It contains published accounts of certain well known corporations or presents situations, more or less complicated but always plausible and such as may be actually found in many instances. The cases are grouped in chapters, each dealing with principal divisions of the balance-sheet such as current assets and liabilities, prepayments and accruals, fixed assets, etc. Appropriate questions are asked in each chapter concerning the propriety of including certain items under the respective headings and other particulars of treatment. Sometimes the student is asked to state the treatment on books, balance-sheet or operating statement of transactions cited in the text. Some of the chapters specifically or incidentally also deal with analysis and ratios.

Part II briefly deals with bookkeeping, defines its function, gives a brief historical survey of its development, traces items and transactions from journal to ledger and from ledger to balance-sheet and operating statement, deals with journalizing and posting and with the closing of books, also with the relation between statements and books of account, cites cases and gives bookkeeping problems for solution, explains the use of the work-sheet in segregating the trial balance into balance-sheet and profit-and-loss items. In each of the chapters suitable problems are given.

Parts III, IV and V deal with accounting for various items of current assets and liabilities, plant and depreciations, investment, intangibles and their evaluation, funded debt and proprietorship, income and expense. A great variety of problems is given in each chapter, testing the judgment of the student and his understanding not only of principles of bookkeeping and accounting but also of the very essentials of the cases presented.

The book is an interesting addition to the already existing material. It is apparently not intended for self-study, as no answers to the problems are given in the book. As in the case of other volumes in the series dealing with accounting problems, a teacher's guide or manual is available.

A. VAN OSS

PRINCIPLES OF ACCOUNTING, Volume I, Intermediate, by H. A. FINNEY, *Prentice Hall Inc.* 765 pages. 1934.

The name of a well known and admired author causes one to pick up a new volume bearing his name with anticipation of unusual pleasure, or profit, and it was in this spirit that I opened *Principles of Accounting*, for Mr. Finney enjoys a happy reputation as a prolific and able writer, widely and well known throughout our profession.

The volume covers a wide territory in its thirty chapters and 534 pages; to which are added 234 pages containing questions on the text. The opening chapters are devoted to a brief discussion of single and double entry, of working papers and of classification of accounts. Then follow five chapters on Companies to which I shall refer later; a clear and simple treatment of the elements of actuarial science, average date and interest; a discussion of notes receivable, consignments, inventories, instalment sales, depreciation, various assets and liabilities; closing with chapters on reserve funds, correction of statements, analysis of working capital, miscellaneous ratios, analysis of profit-and-loss and two chapters on statement of application of funds.

That field is so large that detailed discussion of it is impossible in a review, but certain qualities are outstanding throughout the work. The illustrative examples are numerous, well chosen and really illuminate; the author desires to place before the reader, as fairly as possible, divergent views which exist on certain controversial matters and, as one would expect, all those details directly associated with mathematics—such as interest, present values, instalments, depreciation, ratios, etc.—are excellently set forth. The book, as a whole, contains a large mass of useful and well arranged information; it will prove useful to the student as a text-book and to the accountant as a work of reference.

The author's two chapters on funds and reserves at once dispel any doubt as to the meanings—and differences—of these two terms. Mr. Finney insists that a fund must, of necessity, always be an asset, while reserves must always have credit balances: in other words, they are not hermaphrodites, although, as Mr. Finney says, there is a tendency to treat them as such in institutional and municipal accounting.

The above remarks apply to such matters as usually fall within the scope of an audit of an active corporation; such work as falls on advanced junior, or on senior, accountants, and is more or less governed by a fixed routine. When we come to those matters which would be handled by a principal, or by a managing clerk—which are sometimes indicated by the rather unhappy expression "higher accountancy"—something more must be said. There I feel obliged to part company with the author, and fear that this feeling will be shared by many members of the profession.

A typical instance, showing the grounds for such fears, is found in the treatment of treasury stock and net worth. While the latter term does not appear in the index it is frequently used and, probably, all will agree that it is always the difference between the assets on one side and the liabilities and reserve accounts on the other. Therefore, the purchase of any treasury stock, whether at par, at a premium, or at a discount, consumes some asset and reduces the net worth; similarly, the sale of treasury stock must inevitably lead to an increase in net worth. Yet Mr. Finney writes on page 89 as follows: "Treasury stock is acquired at a premium of, say, 10 points. The entry for the purchase of the stock should be:

Treasury stock......................	$100.00	
Surplus...........................	10.00	
Cash..........................		$110.00

"Surplus should be charged immediately with the premium, because the net worth was reduced at the time of purchase. If the stock is resold: (a) at a discount, the net *worth is still further reduced*, and the transaction should be recorded as follows:

Cash.	$97.00	
Surplus.	3.00	
Treasury stock.		$100.00"

The italics are mine and it is possible that Mr. Finney intended to say that, in the above example, the amount of the *discount* reduces the net worth—but I can not resist the impression that a student would be both confused and misled.

Five chapters are devoted to corporations, which are dealt with in considerable detail, a large part of the last of these being devoted to the treatment of surplus. Here, again, I fear that the majority of accountants will find difficulty in subscribing to the opinion expressed on page 110, where after deploring the lack of a generally accepted definition and a generally observed practice, Mr. Finney writes, "No great benefit will accrue from the use of a capital surplus account until a standardization of practice gives its balance a definite significance."

It is true that opinions differ as to what should be included in a surplus account; it is true that the committees on terminology and on earned surplus have had difficulty in drawing definitions acceptable to all; it may be true that —as our author says—"a capital surplus balance in a balance-sheet has no universal and definite significance," and it is true that while it may be lawful to pay dividends out of capital surplus in one place, it becomes illegal directly one crosses an imaginary line and enters an adjoining state.

It is the existence of these very conditions that has led the profession to divide "surplus" in many parts—so many, perhaps, that there is foundation for the statement that the word "surplus" should never be used without a qualifying adjective.

This is not the opinion of any one person but of the great majority of leading accountants in the United States.

Opportunities seldom occur for a joint expression of opinion by acknowledged leading authorities, but all will admit that the committee which prepared *Verification of Financial Statements* was composed of men of eminence, brought up in different schools, and often holding divergent opinions; yet in regard to this matter of surplus they speak freely and positively when they direct that, when occasion requires, there shall be several surplus accounts, and they name as examples,

"(a) Capital or paid-in surplus
(b) Surplus arising from revaluation of capital assets
(c) Earned surplus (or deficit)"

Similar division of surplus is called for in the federal income-tax returns and, of still more importance to accountants—in the registration form prepared by the federal trade commission in administration of the national securities act.

The examples given by Mr. Finney, of a balance-sheet and a comparative balance-sheet show only one surplus account and, although a detailed analysis of this is provided for, no reader can form from the balance-sheet any idea as to the source, or sources, of the amount shown against surplus.

Frequent recent articles in THE JOURNAL OF ACCOUNTANCY seem to confirm my views and to warrant the statement that the unmistakable trend of our leaders today is to maintain a number of surplus accounts, among them one in the nature of earned surplus, which should include all earnings from regular operations and should exclude all others. For example, would any of our leading firms today include profit on the sale of treasury stock, from unrealized increased appraisals, and from earnings from current and regular operations, all in one account. Surely, the answer must be in the negative.

The opinions expressed in the book lend emphasis to the demand for generally accepted definitions of the various surplus accounts and for a standard of practice. These things we in this country must work out for ourselves, for—curious as it may seem—the term "surplus account" is not to be found in the encyclopædic dictionaries of Pixley of Lisle, or Dawson, or of that other friend of our youth, Professor Dicksee: the use of the term appears to be especially favored by American accountants.

The volume contains so much that is useful—and this is ably set forth, but I fear that the views expressed in some statements, on some of the most important subjects, differ widely from those held by the vast majority of leading accountants. There is danger that a student-reader, finding so much that is excellent, will accept the book as a whole. In that case he may, in later years, find himself in difficulties.

Finally, the publishers are to be complimented on the form of the book, on its printing and, especially, on the use of paper and binding which allow the pages to lie flat wherever the volume may be opened.

WALTER MUCKLOW

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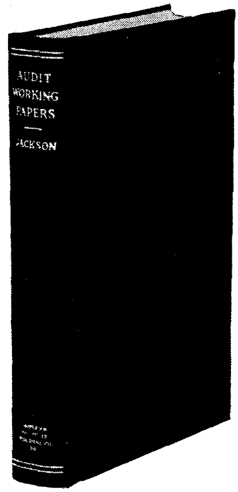

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